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SRI International

LESSONS LEARNED FROM WORLDWIDE PRIVATIZATION EXPERIENCE RELEVANT TO ZAMBIA

FINAL REPORT

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Prepared by: SRI International

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1611 N Kent Street • Arlington, VA 22209-2192 • (703) 524-2053 • FAX: (703) 247-8569 • Telex: 6714879 (SRI DC)

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PREFACE

The purpose of this document is to provide assistance to USAID/Zambia and other USAID Missions throughout Africa with the development of their country privatization strategies. The report was commissioned by the Africa Bureau's Office of Operations and New Initiatives (AFR/ONI), under the Privatization and Development Project (Contract No. DPE-0016-Q-00-1002-00).

USAID/Zambia is funding a comprehensive Privatization Support Project designed to assist the Government of Zambia (GRZ) with the privatization of at least 50 parastatals. As one of the first activities related to that project, USAID/Zambia would like to provide the Zambia Privatisation Agency (ZPA) with useful information on lessons learned from elsewhere in the world that are relevant to the Zambian privatization program.

As a first step in the preparation of this report, USAID/Zambia provided the contractors with a Scope of Work which included a list of key strategic and policy issues relating to privatization that are of particular concern/interest to Zambia.

This report uses case studies and reviews of lessons learned elsewhere which could be used in Zambia and other African countries' privatization efforts. It is hoped that these case studies and analyses will assist USAID missions and their country counterparts in understanding how key strategic and policy issues relating to privatization have been handled in other countries.

Chapters I-XI of this report focus on worldwide experiences on key issues related to privatization. Chapter XII attempts to synthesize the lessons learned from worldwide privatization experience, and draw some initial conclusions about how lessons from elsewhere can be applied in Zambia.

The project was undertaken by Peter Boone, Ophelia Yeung, and John Normand from SRI International, and Stephanie Francis from Price Waterhouse. Danielle Abba from SRI prepared the graphics work for the document.

This report synthesizes information collected from literature surveys and interviews conducted with individuals as well as representatives of official, academic, and government organizations. However, the findings and recommendations, as well as any errors or omissions, are solely the responsibility of the study team.

B

EXECUTIVE SUMMARY

Based on the worldwide experiences of a number of developed and developing countries, several practical lessons can be drawn to guide countries embarking on new privatization programs. These lessons learned are highlighted in this executive summary, and presented in greater detail in the report which follows.

KEY LESSONS LEARNED ABOUT PRIVATIZATION:

ENTERPRISE SELECTION AND CLASSIFICATION SHOULD FACILITATE QUICK ACTION: An important first step in the privatization process is to select SOEs for privatization, restructuring, or remaining public. For this purpose, various enterprise classification systems have been utilized in different countries, based on factors such as the strategic importance and commercial viability of the enterprise, market structure (monopoly versus competitive market), company size, and sector.

Since these selection and classification systems are not mutually exclusive, they could be used in different stages of the privatization process, or utilized interactively at any stage. The key is to establish a functioning classification system at an early stage to facilitate quick action to sell, restructure, or liquidate enterprises. Without quick action, the classification exercise can risk bogging down the overall privatization program.

MAINTAIN DIVERSE PRIVATIZATION PORTFOLIOS There is no single best method for privatizing different types of companies. Since the choice for the most appropriate method will depend on the objectives of privatization, and country, sector, and SOE conditions, a variety of privatization methods should be pursued concurrently to maximize benefits of each method.

- Public offerings of shares are appropriate for larger, usually profitable enterprises that can attract large number of investors. They permit widespread share ownership, facilitate mobilization of local financial resources, and are generally open, transparent, and accessible to small investors. However, public share sales are often complex and time consuming, and are only feasible in countries where the stock market is reasonably active.

- Private share sales are appropriate in cases where specific management or technical expertise is sought or the stock market is not well developed. The main disadvantage is that they may give rise to charges of favoritism and lack of transparency.

- The sale of assets is often the preferred method in many countries when the SOE is not saleable as a going concern. The main advantage of asset sales is that they usually absolve the buyer from any past liabilities.

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- Management/employee buy-outs are often a good alternative to liquidation. They help preserve jobs and avoid the substantial costs of closing down an enterprise.

- Privatization of management through leasing and management contract is often an effective first step toward full privatization. However, private management is only a temporary solution and does not bring the full benefits of complete privatization such as increased investment.

- Free transfer of ownership to workers and managers is often most feasible in the privatization of a small business, where the net worth of a small company often does not justify the costs of a detailed valuation and negotiation for sale.

- The voucher system, which is widely used in Russia Poland and the Czech Republic, is a popular mechanism for the free distribution of shares to ordinary citizens and small investors. The major disadvantages of the voucher system are the high administrative costs, and its tendency to diffuse ownership so widely that effective control on management can be limited.

TAKE FULL ADVANTAGE OF FINANCIAL MARKETS: Even in developing countries where the financial markets are not very sophisticated, a variety of financial instruments can be utilized to mobilize local resources to finance privatization.

- In countries where capital markets are sufficiently organized, public flotations offer the advantage of wide accessibility and openness, encourage widespread shareholding, and serve to create a class of citizens who will have a stake in preventing re-nationalization in the future.

- In developing countries where the stock market is not very well developed, the bond market is often deeper and more active than the equity market, and can serve to mobilize domestic capital to finance privatization. In addition, bond financing offers investors the advantage over equities of more stable returns and seniority in debt repayment.

- Debt-equity swaps are useful when large debt overhangs may deter foreign investors from investing in former SOEs.

- Investment funds are increasingly utilized especially in the context of mass privatization programs in Eastern European countries.

ESTABLISH CLEAR AND TRANSPARENT CRITERIA FOR VALUATION METHODS AND THE DISPOSAL OF ASSETS: Various methods exist for determining the value of SOEs before privatization. Selection of an appropriate method will depend upon the objectives of the government, the quality and reliability of data, and the condition of the enterprise.

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In addition to the existing assets and liabilities of the firm, other factors must be taken into account when determining the true value of the firm. These other factors include commitments the new investor may be required to make on: employment guarantees; training; additional investment obligations; severance pay; or environmental clean up. These commitments should be taken into account when determining the value of the SOE. The valuation price is normally lowered when these obligations are taken into account.

Pre-qualification procedures help governments to establish additional non-price criteria for privatization, and help ensure transparency in the selection process. Pre-qualification procedures are often required for private sales when specific management or technical expertise is sought. Pre-qualification criteria frequently include: general business reputation; financial strength; record of performance; and experience in the sector.

MODIFY LEGAL, REGULATORY AND POLICY FRAMEWORK TO ACCOMMODATE PRIVATIZATION: The legal framework governing various aspects of business such as property law and corporate law often has to be modified prior to the privatization process to accommodate the change of status of former SOEs. In addition, a sound regulatory framework will have to be established to ensure competition in competitive sectors, and to regulate monopolies in noncompetitive sectors.

Experience in many countries has shown that privatization has created more "efficiency gains" when it is part of a broader macroeconomic reform program aimed at improving the business operating environment. These reforms usually cover the areas of pricing, capital markets, trade, investment, taxation, and labor. Not all of these policies can be adjusted at once, nor should privatization be delayed until all the market imperfections have been eliminated. However, policy reforms should be included in privatization planning and properly sequenced. Privatization should serve as a catalyst for policy reform.

ENCOURAGE LOCAL OWNERSHIP THROUGH DIFFERENT TECHNIQUES: Several different techniques can be employed to increase participation from local investors in the privatization process, including employee stock ownership plans (ESOPs), share allotment schemes, special incentives for small share purchases, voucher systems, and the use of extensive publicity and promotion. These techniques frequently involve a combination of allocation preferences and special credit arrangements which favor small share purchases. Publicity and promotion are also critical in educating the public on the rights and responsibilities of shareholding and inducing widespread participation in the cases of public offering.

ANTICIPATE OPPOSITION TO PRIVATIZATION AND DEVELOP STRATEGIES TO OVERCOME IT: Opposition to privatization may arise from a variety of sources which have vested interests in preserving state ownership of the majority of enterprises. Political opposition leaders may exploit the issue to attack the ruling party; intellectuals may oppose privatization for ideological reasons; the military may want to preserve state control of strategic sectors; state bureaucrats and workers in SOEs may fear losing their job security.

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A useful strategy for overcoming political and social opposition to the privatization process is to have top government officials demonstrate solid commitment to privatization though such means as public statements to marshall public support. Public relations campaigns are extremely important in helping the government present a persuasive case to the public. Military and labor opposition may be diffused by early consultation and efforts to involve these groups in the privatization process, as well as reasonable compensation in the case of displaced labor. To overcome bureaucratic opposition, a special super ministry can be created to provide overall coordination and override the objection from various ministries. Overall, opposition to privatization will be weakened by creating an open and transparent privatization process which gives high priority to widespread share ownership.

SETTLE ENVIRONMENTAL LIABILITIES BEFORE PRIVATIZATION: In the cases where the potential environmental liabilities (past and current pollution on-site and off-site) will significantly affect valuation of SOEs, environmental audits should be conducted and responsibilities for the cost of clean up should be clarified before privatization. Investors in former SOEs usually want to limit the extent of their liability through indemnification.

PROVIDE SOCIAL SAFETY NETS TO EASE THE EFFECTS OF LABOR RETRENCHMENT: Large-scale labor retrenchment resulting from privatization may cause considerable antipathy among workers and lead to labor opposition to the privatization process. A variety of programs can be implemented to compensate workers, and to assist them in the adjustment to alternative employment or self-employment opportunities. These programs include severance pay, employee stock ownership plans, job search assistance, job training, special credit programs, and employment generating programs. Experience in many countries has shown that severance payments are often easier to administer, are more cost-effective, and are more likely to have a direct impact.

CREATE AN INVESTMENT-FRIENDLY ENVIRONMENT TO ATTRACT FOREIGN INVESTORS: To induce the participation of foreign investors in privatization, governments need to create a friendly investment climate, which generally entails streamlining business registration procedures, and reducing restrictions on: foreign exchange convertibility and repatriation; foreign ownership; and expatriate employment. The investment regime and the divestiture laws should be set under a consistent policy framework to avoid confusing investors. Foreign investment laws and regulations should be clear, transparent, and consistently applied.

IDENTIFY HIGH POTENTIAL BUYERS THROUGH INVESTOR SEARCHES: When target investors are sought through private sales and liquidation sales, investor searches can help locate high-potential buyers. Most investor searches include one or more of the following techniques: direct mail campaigns and telemarketing, participation in trade shows, targeted advertising, investment seminars and investment missions.

DEVELOP TECHNICAL SKILLS FOR SUSTAINABLE PRIVATIZATION PROGRAMS: The development of technical skills in the areas of valuation, investment finance, negotiations, and legal reform is vital for countries to achieve sustainable privatization programs.

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I. ENTERPRISE CLASSIFICATION SYSTEMS

ISSUE: Countries utilize different systems to classify or group SOEs before they are divested. What are the main classification systems, and what are the lessons learned from countries which have used these different classification systems?

A. Principal Classification Systems Used

Governments have established different classification systems to facilitate privatization. The main classification systems used include one or more of the following factors: **(i) strategic importance of the company; (ii) commercial viability of the enterprise; (iii) market (monopoly or competitive market); (iv) size of the company (small, medium, or large); and (v) sector of activity.**

<u>Classification Systems Based on Strategic Importance and Commercial Viability</u>

An important first step in the privatization process is deciding which enterprises will remain public, which will require need restructuring, and which should be privatized or liquidated. Several governments (Malaysia, Madagascar, Togo, Somalia, Kenya, etc.) have followed the classification system shown in Chart 1.1 on the following page. This system classifies all public enterprises as "strategic" or "non-strategic, and "viable" or "not viable". Such a system enables a clear decision about each category. As such, the system can be a very good starting point for privatization or restructuring decision making. This particular system is useful for all countries embarking on a major privatization program.

The terms "strategic" and "viable" can mean different things to different governments. In Togo, the government has defined "strategic" as SOEs which fulfilled at least one of the following criteria: (i) provides a public service function; (ii) plays a fundamental role in the exploitation of the country's natural resources (e.g., the phosphate company); or (iii) earns profits which provide a substantial and at present essential contribution to the budget.

In Kenya, the government's definition of strategic refers to enterprises, or parts of enterprises or commercial functions of regulatory bodies, that are deemed vital to national security and those providing essential goods or services, especially infrastructure and utilities. All other parastatals are to be classified as non-strategic. In the same country, "viable" parastatals include all enterprises that are commercially profitable under the current and projected environment. All others are classified as "non-viable".

Chart 1.1

COMPANY CLASSIFICATIONS AND ACTIONS

- **PLACE ALL COMPANIES INTO ONE OF THESE CATEGORIES**
- **SELECT APPROPRIATE ACTION**

	STRATEGIC	*NON STRATEGIC*
VIABLE	***Retain in Public Sector***	***Divest to Private Sector***
NONVIABLE	***Rehabilitate through Commercialization***	***Liquidate***

A similar classification scheme was applied to agricultural parastatals in Madagascar by the Ministry of Agricultural Production and Agricultural Reform, which defined "strategic" as an enterprise which fulfills a "priority role for the state and carries out activities which under present conditions cannot be undertaken by any other mechanism". In the same country, "non-viable" means that "the enterprise does not and could not run along commercial lines at a profit."[1]

Clearly, these definitions are not perfect and leave room for some subjective interpretation in order to become operational. In addition, it should be noted that it is not necessary that all firms be classified at the outset. Rather than striving for a perfect classification system, it is more **important to place emphasis on quick action to sell, restructure, or liquidate some of the extreme cases.** Otherwise, reform programs tend to lose momentum or can stall over classification discussions, which risk becoming an academic exercise.

<u>Classification Based on Competitiveness of the Market and Country Regulatory Conditions</u>

A classification system (see Chart 1.2 below) now being encouraged by the World Bank[2] categorizes enterprises by two factors: (i) **nature of the market**; and (ii) **country conditions.** The first factor, **nature of the market**, is broken down into either "competitive" or "noncompetitive". One of the premises of this classification system is that privatization of enterprises in competitive sectors such as industry, agriculture, airlines, or retailing is likely to yield solid and rapid benefits as long as there are no economy-wide distortions which hinder competition. Even under such distortions, the recommended action is to sell, with attention being paid to reducing the distortions.

The second factor in this classification system is **country conditions**, or the overall macroeconomic policy framework and capacity to regulate. As Chart 1.2 demonstrates, privatization of companies in both competitive and noncompetitive sector markets will yield more immediate and greater benefits in more market-friendly policy environments. For this reason, it is important to consider privatization as part of an overall package of economic policy reforms. Such a package can entail reforms in such areas as exchange rate, fiscal policy, pricing, and trade policy.

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1 See "The Reform of State-Owned Enterprises: Lessons Learned from World Bank Lending," by Mary Shirley, the World Bank Policy and Research Series, 1989.

2 See <u>Privatization: Lessons of Experience</u>" by Sunita Kikeri, John Nellis, and Mary Shirley, the World Bank, 1992.

Chart 1.2

Privatization: A Framework for Decisionmaking

- PLACE ALL COMPANIES INTO ONE OF THESE CATEGORIES
- SELECT APPROPRIATE ACTION

	Competitive	Noncompetitive
High capacity to regulate; market-friendly	➡ Sell	➡ Ensure or install appropriate regulatory environment ➡ Then consider sale
Low capacity to regulate; market-unfriendly	➡ Sell, with attention to competitive conditions	➡ Consider privatization of management arrangements ➡ Install market-friendly policy framework ➡ Install appropriate regulatory environment ➡ Then consider sale

Source: Kikeri, Nellis, and Shirley Ibid.

In cases where privatization involves enterprises in noncompetitive markets -- usually large SOEs operating as natural monopolies in such areas as power, water supply, and telecommunications -- a legal and regulatory system must be in place to protect consumers. Regulatory capacity is often, but not always, correlated with income; thus **middle income countries tend to be better in a better position to privatize enterprises in noncompetitive sector markets.**

The privatization process is easiest if the enterprise is in a competitive sector and the environment is market-friendly. The sale of a parastatal enterprise from a competitive sector in a favorable country setting (the upper left quadrant in Chart 1.2), requires little more than adequate attention to transparency and competition among bidders.

This particular classification system is more of a conceptual framework than an operational system. One of the major points to be learned from this system is that it is much easier to first privatize companies in competitive markets where the need to introduce new regulations is minimal.

<u>Classification by Size of the Company</u>

Having made the strategic decision of whether or not to sell specific parastatals, many countries have grouped their companies to be privatized by size. One of the principal benefits of grouping by size is that it can help **simplify the planning of the next stage of the privatization process -- determining what method of privatization to use.** Following the size classification system, specific methods of privatization are established for each size category. Clustering companies by size can facilitate decision making and can thereby increase the speed of privatization.

Poland is an example of a country which organizes companies to be privatized by size (see Chart 1.3 below). According to the Polish classification system[3], large-scale enterprises are the 500 largest companies nationwide, as ranked by sales revenues. These companies are responsible for about 70 percent of the country's industrial production. For the firms in the large-scale category, the Polish authorities have determined that ownership must be vested with several groups or with a large foreign buyer.

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[3] See <u>Reforming Central and Eastern European Economies</u>, The World Bank, 1991.

Chart 1.3

POLISH SIZE CLASSIFICATION AND ITS IMPLICATIONS FOR DIVESTITURE OPTIONS

DIVESTITIVE OPTIONS

LARGE-SCALE

- Ownership vested with several groups
- Ownership vested with large foreign buyer

MEDIUM-SCALE

Majority ownership can be vested with one or more buyers through:

- management buy-outs
- worker buy-outs
- auction sales

SMALL-SCALE

Majority ownership can be vested with one or more buyers mainly through:

- leasing
- auction sales
- free distribution

In the same system, medium-sized firms have between 200 and 1000 employees. For privatization of medium-scale enterprises, a majority stake can be sold to a single buyer either through a management-worker buy-out, or in a sale to an outside group. Small-scale privatization in Poland refers to enterprises with less than 200 employees, mainly in the retail trade. For small-scale firms, privatization will be accomplished mainly by leasing, auction sales, or free distribution to workers and managers.

Russia has been following a size classification system similar to Poland's. In the Russian classification system, large firms include Russia's 5,000 largest firms measured by sales revenues and number of employees. Medium-sized firms fall in between the large and small firm classification cutoffs. Small-scale firms are firms with less than 200 employees and valued at no more than 1 million rubles. Small scale businesses include stores, restaurants, barber shops and other retail businesses.[4]

Grouping enterprises by size can help organize the next step --which is determining which privatization method to use. Grouping by size makes sense if the country has identified a minimum number of companies (25, for example) for privatization. In this way, size classification helps organize buyers, technical assistance and implementing methods.

Classification By Sector

Many countries have classified enterprises by sector before privatization. Poland, Hungary, and Mexico are examples of countries which have grouped companies according to sector of activity.

One of the advantages of grouping enterprises by sector is that such an arrangement allows buyers to consider purchasing clusters of firms in their sector of interest, instead of being restricted to appraising companies on a one-by-one basis. This approach is particularly effective in attracting larger foreign companies in cases where many of the firms for sale are otherwise too small to draw their attention. When buyers purchase several firms in one sector they are able to achieve horizontal or vertical integration in their sector of operations -- which can represent an efficiency gain as long as there is no monopoly control.

The host country privatization agency can also benefit in several ways from the grouping of firms by sectors. For example, host country privatization agencies can benefit from sectoral groupings when they manage to sell blocks of firms to the same buyer, thereby reducing negotiation time and costs. In addition, grouping of firms by sectors can provide a basis upon which to organize international assistance and technical assistance support for privatization. This is particularly important in countries where many different donors are involved in the privatization program, and donors need clear guidelines as to which enterprises or sectors they will be taking the lead in for privatization support.

[4] See Reforming Central and Eastern European Economies, ibid.

Similar to the size classification applicability, grouping by sector makes sense when at least 25 companies are being privatized by a country.

B. Lessons Learned About Classification Systems

1. Classifying firms for privatization, restructuring, liquidation, or retention is a useful starting point for the privatization process.

2. It is not necessary that all firms be classified from the outset. Rather than striving for a perfect classification system, the emphasis should be on quick action to sell, liquidate or restructure some of the most extreme cases.

3. Without quick action, the classification exercise can risk bogging down the overall privatization program.

4. Privatization is easiest in competitive sector markets in favorable country settings. Countries with low capacity to regulate should first emphasize privatizing firms in competitive, tradable sectors.

5. Classifying firms by size can help simplify planning of the next stage of the privatization process -- determining what method of privatization to use. Clustering companies by size can facilitate decision making and can thereby increase the speed of privatization.

6. Grouping firms by sector can help attract larger foreign investors when the small size of individual firms would have otherwise discouraged them from buying. In addition, grouping of firms by sector can also be helpful to host countries when they are "parcelling out" international assistance and technical assistance support for privatization.

II. PRIVATIZATION METHODS

ISSUES: What are the most common privatization methods? What are the main steps involved in the various privatization options and which methods are most appropriate for different types of situations?

A. Principal Privatization Methods

Several privatization techniques can be used to bring about total, partial, or gradual divestiture of an SOE. There is no single best method for privatizing companies. The choice of the particular method will be dictated by the objective being sought, the country and sector conditions, the commercial viability of the firm, and other factors.

The most commonly used methods[5] of privatization include:

- Public offering of shares
- Private offering of shares
- Asset sales or liquidations
- Employee or management buy-outs
- Management or leasing contracts
- Free Transfer of Ownership
- Deregulation of Activity

Most successful privatization programs have pursued a variety of these methods concurrently, maintaining a diversified privatization portfolio.

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[5] The different privatization methods discussed in this chapter are based largely on a method classification system developed by Charles Vuylsteke in Techniques of Privatization of State-Owned Enterprises, World Bank Technical Paper No. 88, Volume I, 1988. According to this classification system, privatization techniques are largely determined by the legal status of the company and whether the company is a going concern (with assets and liabilities) or merely a dissolved entity with only assets.

Public Offering of Shares

Under public share offerings[6], the state sells to the general public all or part of the stock it holds in an SOE which are going concerns in public limited companies. While technically the public offering is a secondary distribution of existing shares, it is commonly handled as a primary issue.

A prospectus is prepared for the offering, and the services of an investment bank are usually required for this step of the process. The investment bank or a syndicate may also underwrite the offering. The fees and commissions required by investment banks and other intermediaries can be significant. In the case of a listed company of which the shares are already traded, the government may simply sell the share on the stock exchange without any valuation required.

In order to be successful, public offerings require that:

- The company be a sizeable going concern with a reasonable record of profitability;
- A full body of financial, managerial and technical information on the company be disclosed to the investing public;
- There is ample liquidity available in the local market to subscribe to the issue; and
- The equity market is sufficiently developed, or alternatively that some institution, such as a securities regulatory body, undertakes to inform, attract, and protect the general investing public.

Public share sales are appropriate for larger, usually profitable and well managed companies that can attract large numbers of investors. Their main **advantages** are that they permit widespread ownership, allow the broader local financial resources to be tapped, and are normally characterized by openness and transparency, and accessibility to small investors.

The main **disadvantages** of public offerings are that they are complex, time consuming, and potentially expensive. In addition, the underdevelopment of equity markets in many developing countries is often a potential constraint. Finally, large public offerings may "crowd out" resources and savings for the creation or expansion of other productive enterprises. When the volume of existing resources (or the capitalization of the stock market) is not on the increase, large-scale offerings may soak up all the available resources.

[6] See Chapter IV of this report for the Jamaica case study as an example of a successful preparation of a public offering.

Private Sale of Shares

Under this method of privatization, the government sells all or part of its shareholding to a pre-identified single purchaser or group of purchasers. Under private sales, the SOE must be a going concern set up in the form of a corporation. The transaction can take various forms, such as selling to another corporate entity or a private placement targeting specific groups like institutional investors.

The two most common ways of handling the private sale of shares are:

- Invitation to bid through public tendering
- Direct negotiations

When specific management or technical expertise is sought for the company, private sales through public tendering or direct negotiations might be the most appropriate method. For invitations to bid and for direct negotiation, many countries have developed guidelines to pre-qualify bidders and criteria for selection including: general business reputation; financial strength; record of performance; and experience in the sector.

In the case of the Philippines, the Operating Guidelines of the Asset Privatization Trust provide minimum standards for bidding. The use of sealed bids must be followed; negotiated offers can be resorted to only if bidding proves unsatisfactory or inappropriate. In Argentina and Brazil the Privatization laws govern bidding and auction procedures.[7]

When the company is a mixed enterprise, direct negotiations with existing private shareholders are often the preferred method of privatization, particularly when existing private shareholders have preemptive or preferential rights. In many countries, existing shareholders are given "rights of first refusal" to meet bidding prices or pre-determined prices based on valuations or other methods of price determination.

Even when direct negotiation is used, many countries specify procedures that ensure a competitive process is employed. For example, procedures for direct negotiations often include some fall-back procedures for the government to resort to such as tendering if the price offered by the private party (e.g., existing shareholder) falls short of a target price such as a valuation price.

One of the **advantages** of private share sales is that strong owners with relevant industrial, financial, or commercial experience can be targeted for pre-qualification. The prospective owners can be identified in advance and can be evaluated. They can be selected on the basis of the expected benefits they will bring in terms of management, technology, access

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[7] See p. 18 in Vuylsteke, op. cit.

to markets, etc. An additional advantage of private share sales is that they may be the only feasible alternative in the absence of developed equity markets. Finally, private share sales are much simpler and less costly than public offerings in terms of disclosure, legal requirements, and transaction costs.

The main **disadvantage** of private sales is that they may give rise to criticism about the lack of transparency in the selection of buyers. In addition, if a majority of the firms are being privatized by private share sale, there may be concerns about inadequate distribution of ownership across the country. Pricing is also a difficult area for private share sales. In order to overcome these obstacles, strict mandatory procedures for pre- qualification of buyers and selection of bids are required.

Asset Sales/Liquidation

Under the two previous methods of privatization, the private investor purchases shares in an SOE that is a going concern with all of its assets and liabilities. In the case of asset sales, however, the transaction consists of the sale of assets, rather than the sale of a going concern. For asset sales, the government may sell the assets directly or the SOE may dispose of the assets itself. The assets may be sold off individually or together as a new corporate entity.

There are three principal forms in which the sale of assets can be undertaken:

- Competitive bidding;
- Auction; and
- Direct negotiation with a private buyers, usually following an extensive investor search.

There are several different situations in which the sale of assets is the preferred method of privatization:

- When it is desirable to **sell only a part of an SOE** with the core of the company remaining intact. This is a useful way of achieving partial privatization and in the process downsize the SOE.
- When the **SOE is not viable and not sellable as a going concern**, it may have to be **dissolved and liquidated**. Following liquidation, the assets are sold, with or without the accompanying liabilities, to a private party or parties. The new owner then creates a new company to take over all or part of the activities of the defunct SOE. Liquidation followed by asset sales is the most common form of privatization to date in developing countries.
- When an enterprise may be **saleable as a going concern**, but for various financial and legal reasons, a sale of assets is preferable. This method is often preferred in Eastern

Europe and many developing countries where new investors are very reluctant to take over the company in its current legal form because of the potential liabilities they might be assuming.

In many developing country cases, SOEs are not sellable as going concerns, thus the sale of assets becomes the preferred --if not the only -- alternative. Companies which are not viable and have negative net worth generally should be closed down through receivership or bankruptcy procedures, followed by asset sales.

The principal **advantage** of asset sales is that they encourage private investment because they usually absolve the buyer from any past liabilities. Many of these liabilities from the past are not fully known or disclosed at the time of sale. To avoid such problems, governments often initiate administrative liquidation, whereby they dissolve the corporation, but assume residual liabilities that the SOE has incurred, but may not be fully identified, until liquidation.

The main **disadvantage** of liquidation/asset sales is that in some instances liquidation is more costly than restructuring, as full dissolution and winding up may involve the settling of all liabilities and paying severance pay to all personnel.

Management/Employee Buy-outs

Management buy-outs (MBO) generally refer to the acquisition of a controlling shareholding in a company by a small group of managers. Employee buy-outs involve similar transactions where employees acquire a controlling interest in a company. In other cases, management and employees together acquire a controlling shareholding in what is sometimes called a management/employee buy-out.

In the case of most buy-outs, a holding company is created through an equity issue subscribed to by management or employees. The holding company then acquires the SOE which is to be privatized, using equity capital, and in the case of leveraged buy-outs, substantial borrowed funds. In Poland (see Chapter I of this report), management/employee buy-outs are the preferred method of sale for medium-sized companies. Egypt (see Chapter VI) of this report used an ESOP to encourage employee ownership of the Alexandria Tire Company.

Management/employee buy-outs require the presence of competent and skilled management and a committed and stable work force. Strong cash-flow potential is also a usual pre-condition for obtaining credit to finance the buy-out.

Management/employee buy-outs are useful means of transferring ownership to SOE management and employees who usually have little capital. Management/employee buy-outs are often the best solution for companies that are not otherwise sellable, and for which the only other realistic alternative is to liquidate. The principal **advantages** of the schemes are that they help preserve jobs, and, if the new company remains in operation, they avoid the substantial costs of closing down an enterprise.

The chief **disadvantage** to these schemes is that in many cases SOEs have weak financial positions and asset values, and managers and employees may have very little capital. These circumstances make it difficult for the managers/employees to secure financing from commercial banking sources. This obstacle can sometimes be overcome through creative financing. An additional disadvantage to the schemes is that managers and employees sometimes have overly-optimistic expectations about the potential profitability of their newly-privatized company. If the new company fails to generate profits and dividends, there can be considerable disappointment. The enthusiasm for improving productivity may eventually wane if there are no dividends forthcoming.

Management Contracts/Leases

Leases and management contracts are arrangements whereby private sector management, technology and/or skills are provided to an SOE under contract for an agreed period of time. While there is usually no transfer of ownership, these arrangements can be used to "privatize management" and operations to increase the SOE's efficiency.

Significant gains can be achieved by bringing in aggressive private management and allowing SOEs to operate like a private firm. Leasing and management contracts are often utilized when the sale of assets cannot be achieved in the first stage, but it is felt that private management will help to improve profitability and will eventually lead to full privatization. They are often used in activities where it is difficult to attract private investors, or in low-income countries where capital markets are weak, and unfavorable policy environments make private investors reluctant to take on ownership of assets in the first instance.

In **management contracts for SOEs**, the government pays a private company a fee for managing the SOE. Management contracts are common in certain sectors such as hotels, airlines, and utility companies where considerable experience has made contract negotiations and monitoring relatively routine. While less common, contract management has also been undertaken in the industrial sector, as in the case of Sri Lanka where management contractors have been utilized to turn around three loss-making textile firms prior to privatization.[8]

Management contracts have the **advantage** in some country settings of being less politically sensitive than actual sales. In addition, they are often an effective first step in restructuring a company and preparing it for full privatization.

Management contracts have important **disadvantages**, however. For example, management contractors typically assume little or no financial risk; operating losses must be borne by the owner (the state) even though it has no control of the day-to-day operations. Many standard management contracts are fee-for-service contracts, payable irrespective of the level of

[8] See Management Contracts: Main Features and Design Issues, by S. Hegstad and I. Newport, World Bank Technical Paper Number 65, 1987.

profits, and, as such, provide little incentive to improve efficiency. In addition, few management contractors provide adequate training for local counterparts, creating a longer-term dependency on a costly system which was intended to be temporary. Many of these risks can be reduced with properly drawn-up contracts, but in many developing countries that involves strengthening the government's capacity to negotiate, monitor, and enforce contractual obligations.

Leases overcome some of the drawbacks of management contracts. The private party, which pays the government a fee to use the assets, assumes more of the commercial risk of the operation since leasing fees are often linked to performance and profitability. Lease arrangements have been widely used in Africa, particularly in sectors in which it has been difficult to attract private investment. Examples include steel and petroleum refining in Togo, water supply in Guinea and Côte d'Ivoire, road transport in Niger, port management in Nigeria, and mining operations in Guinea.[9]

Leases often have built-in incentives to cut down costs, including "sunset clauses" to gradually reduce higher-paid expatriate staff. For example, in Côte d'Ivoire, the lease contract for the water company provided incentives which led to a reduction in the number of expatriate staff from 40 to 12. Technical efficiency, new connections, and billing and collections of accounts receivables were also dramatically improved under the leasing arrangements (See Box 2.1 below).

The main **advantages** of leases, compared with management contracts, is that lessees have much wider control over the work force and assets of the SOE, and assume much more of the financial risks and rewards.

The main **disadvantage** of leases is that, similar to management contracts, they are only temporary solutions. Political authorities often give private lessees the power to turn around a poorly performing company, but if the SOE's earnings improve, the temptation to interfere often reasserts itself. Furthermore, privatizing management through leases does not usually bring the increased investment that is often a major benefit of ownership change.

Transfer of Ownership

Generally speaking, small businesses lend themselves best to the **transfer of ownership to managers/workers** because the level of net worth of a small company does not usually justify the costs of detailed valuations and lengthy negotiations. Free transfer of ownership to workers/managers is one of the preferred methods of privatization of small SOEs in Poland and is also a common form of privatization of small SOEs in Russia.

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[9] See Financing Capital Formation Through Leasing: The IFC Experience, the IFC, 1981.

Box 2.1

Private Management of Water Supply in Côte d' Ivoire

Starting in 1960, the French water utility, SAUR, created an Ivorian subsidiary, the Côte d'Ivoire Water Distribution Company (SODECI). Under a mix of lease and management contract agreements, the company gradually began managing urban and rural water supply systems throughout the country. By 1978 the company's shares began trading on the Ivorian stock exchange. Private Ivorians now hold 46 percent of its share capital, with SAUR retaining 46 percent, employees 5 percent and the state 3 percent. However, the state maintained ownership of the water supply equipment and infrastructure.

Due to effective contractual incentives and the strong managerial expertise of the foreign partner, SODECI achieved remarkable success in urban areas. By the late 1980s, water losses had been cut to 12 percent, and the collection rate had been raised to 98 percent for private consumers. At 130 water connections per employee, labor productivity was double the next best West African water utility. Moreover, through cost reduction incentives the number of expatriate staff was reduced from 40 to 12.

Despite SODECI's excellent record, overall performance in the water sector fared rather poorly, however, because of the government's investment and pricing policies. For example, the government discriminated against urban industrial users by charging higher prices to them than rural users. In addition, government over-investment in water supply infrastructure led to under-utilization of capacity and a breakdown in sector finances.

SODECI's experience demonstrates that private management can improve efficiency, but also reveals the limitations of management contracts and leases in sectors where government still controls prices, investment policies, and (in this particular case) the infrastructure assets.

Source: Kikeri, Nellis and Shirley, op. cit., p. 51.

The main **advantages** of free transfer of ownership to managers/workers are: (i) it involves relatively low transaction costs; and (ii) similar to worker/employee buy-out schemes, it can preserve jobs, avoid the negative impact of closing, and create stronger incentives to improve productivity.

The main **disadvantages** of the scheme, compared with management/employee buy-outs, are: (i) the government receives no revenue from the transaction; and (ii) there can be some questions about the fairness of the scheme -- whereas some SOEs are sold for cash, others are given away for free to workers/managers, creating a windfall gain for selective groups of citizens.

The voucher system, which is widely used in Russia, Poland, and the Czech Republic, is a popular mechanism for the free distribution of shares to ordinary citizens in companies about to be privatized. The principal **advantage** of the voucher system is that it allows ordinary citizens and small investors the opportunity to own shares in private companies. The major **disadvantages** of the voucher system are the time-consuming nature of its implementation, the potentially prohibitive administrative costs involved, and its tendency to diffuse ownership so widely that effective control on management can be limited.

Deregulation

Deregulation is an appropriate way to encourage private participation in economic activities which formerly excluded private companies because of monopolies granted to parastatals. After barriers to entry have been eliminated and appropriate regulations enacted, private firms have been willing to enter into sectors formerly monopolized by SOE companies.

Colombia, for instance, changed its regulations to permit open competition between private and public operators in ports, dismantled the monopoly on the shipping cargo line, and allowed the private sector to provide rail transport services.[10] In other countries, even where monopolies are retained (for example in telecommunications), competitive activities can be spun off, while in-house services can be competitively bid to save costs.

One common result of the removal of monopoly status is for the SOE to wither away. In Somalia, for example, after the Agricultural Development Corporation lost monopolistic control over maize and sorghum marketing, its share in the purchases of these crops dropped from over 80 percent to 1.6 percent.

The **advantage** of deregulation as a means of encouraging privatization is that it can encourage private sector investment with the resulting efficiency gains, without the heavy administrative and legal costs of selling a government company.

[10] See Kikeri, Nellis and Shirley, ibid. p. 43.

The main disadvantages of deregulation as means of encouraging privatization are: (i) it does not completely address the ultimate need to restructure or liquidate the SOE; and (ii) the mere presence of a dominant SOE in a given sector is often enough to deter private investors, who may fear that there will never be a "level playing field" between private and public competitors.

Diversified Privatization Strategy

Most successful countries use a variety of privatization methods simultaneously, maintaining a "diversified privatization portfolio." Emphasis is adjusted over time on the basis of results achieved. Chart 2.1 below indicates one possible diversification strategy. This particular diversified privatization strategy was developed for the government of Kenya by SRI International in 1991. In the Kenya case, an overall target number of firms was established for privatization (139), but individual targets for each privatization method were not set. It was understood, however, that the methods at the bottom of the pyramid from Chart 2.1 (e.g., transfer of ownership and liquidation) were likely to be the most common methods.

B. Lessons Learned About Privatization Methods

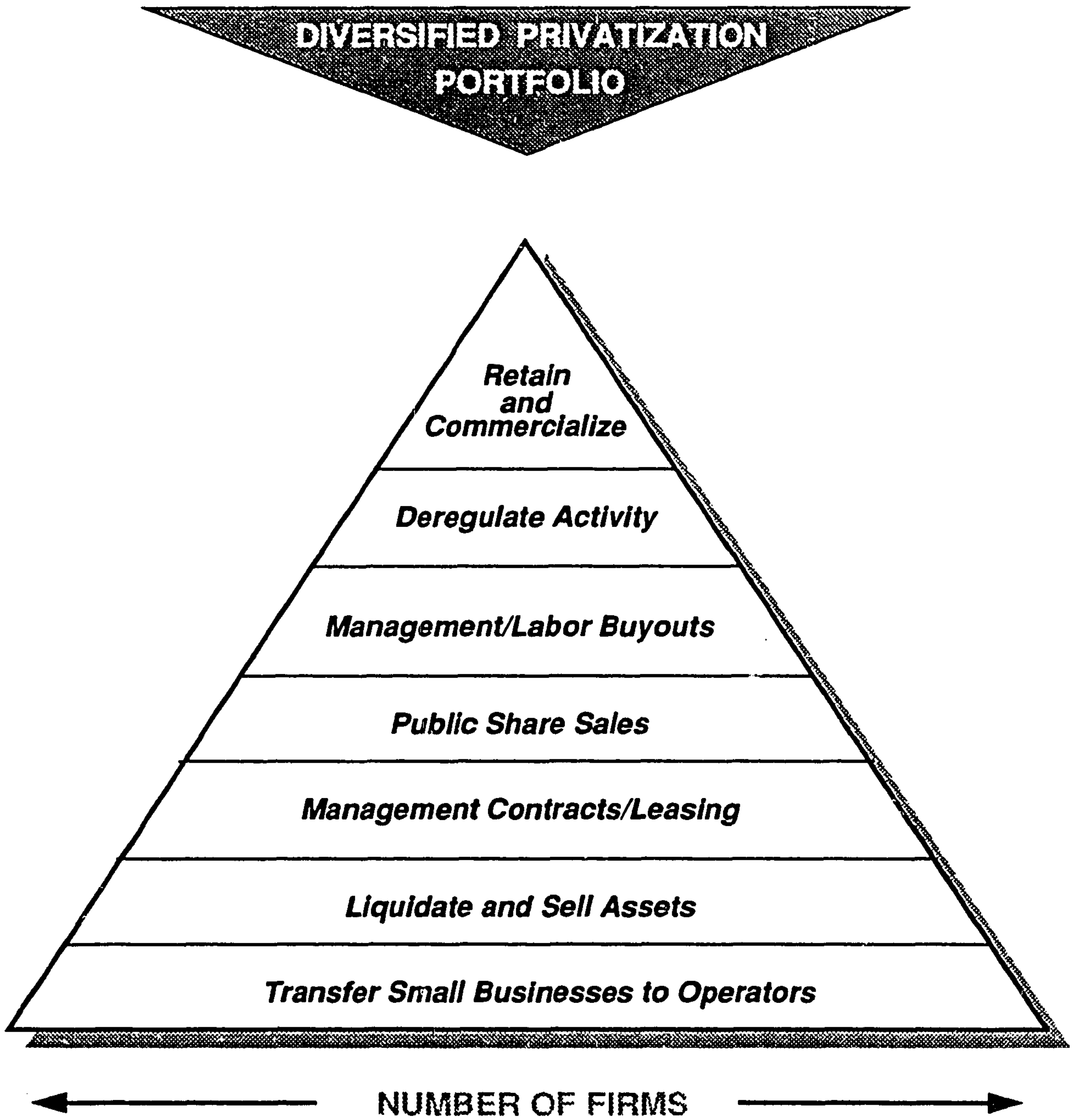
1. Public share sales are appropriate for larger, usually profitable and well-managed companies that can attract large numbers of investors. Share offerings permit widespread ownership, allow broader local financial resources to be tapped, and are characterized by openness and transparency, and accessibility to small investors. Public share offerings have the disadvantage, however, of being complex and time consuming.

2. When specific management or technical expertise is sought for the company, private share sales through competitive bidding or direct negotiations might be the most appropriate method. In order to overcome concerns about transparency and competition, strict mandatory procedures for pre-qualification of buyers and selection of bids are extremely important.

3. In many developing country cases, SOEs are not sellable as going concerns, thus the sale of assets becomes the preferred -- if not the only -- alternative. Companies which are not viable generally should be closed down through bankruptcy procedures, followed by asset sales. From the point of view of facilitating privatization, asset sales are often preferred because they usually absolve the buyer from any past liabilities.

4. Management/employee buy-outs are useful means of transferring ownership to SOE management and employees. Management/employee buy-outs can help preserve jobs, and if the new company remains in operation, avoid the substantial costs of closing down an enterprise.

Chart 2.1



DIVERSIFIED PRIVATIZATION PORTFOLIO
Retain and Commercialize
Deregulate Activity
Management/Labor Buyouts
Public Share Sales
Management Contracts/Leasing
Liquidate and Sell Assets
Transfer Small Businesses to Operators
NUMBER OF FIRMS

5. Leasing and management contracts are often utilized when the sale of assets cannot be achieved in the first stage, but it is felt that private management will help to improve profitability and will eventually lead to full privatization. Privatization of management is only a temporary solution, however, and does not bring all the benefits of full privatization.

6. Generally speaking, small businesses lend themselves best to the transfer of ownership to managers/workers, because the level of net worth of a small company does not usually justify the costs of detailed valuations and lengthy negotiations.

7. Most successful countries use a "diversified privatization portfolio", adjusting emphases over time based on results achieved.

III. VALUATION & GUIDELINES FOR ASSET DISPOSAL

ISSUE: Valuation is a critical step in the privatization process, as the conclusion of a transaction depends upon the buyer and the seller reaching an agreeable price. What is the process by which the value of state-owned enterprises is derived and what are some of the most common issues regarding pricing that arise in developing countries?

A. Principal Valuation Methods

The technical procedures employed in deriving enterprise value (valuation) in developing countries are complicated by several factors. These factors include: weak capital markets; limited transaction activity; inconsistent accounting practices; and imbalances that are characteristic of economies in transition. Under these conditions, arriving at a justifiable value for a state-owned enterprises becomes an increasingly complex process.

Various methods for determining value can be applied to enterprises targeted for privatization. These methods can be generally classified as **asset-based, income-based or market-based.** The asset-based methods interpret company value solely as a function of the worth of tangible assets; income-based methods consider the revenue-generating capacity of the assets to arrive at a fair market value for the enterprise; market-based methods consider the performance of firms in the same or similar lines of business to derive a comparable value for the firm. Selection of an appropriate valuation method will depend upon the objectives of the government, the quality and reliability of data available, and the condition of the enterprise.

Asset-Based Methods

The asset-based valuation methods include both the net book value method and the replacement cost method. **Net book value** is an accounting concept which equates value with the equity of the firm, that is, the value of the assets (carried at historical cost minus depreciation) minus the value of the liabilities of the company. The accuracy of this method depends upon the reliability of the accounting data from which it is derived. Consequently, in countries where accounting standards and practices are weak, this method may not be very reliable. In addition, as an accounting concept, this method does not consider the *actual* condition of the assets which determines how they would be valued in the marketplace. Therefore, the net book value method may distort the **market value** of the assets. For example, a fully depreciated asset would show a book value of zero even though it would have some value on the market, if only as scrap or spare parts.

Alternatively, asset value may be derived using the **replacement cost** method. This method values the company's assets in terms of the current price that would be incurred to purchase comparable assets for replacement. The replacement cost method is seen as preferable to the book value method because it considers current market prices. However, its application may be limited in situations where the assets to be valued employ obsolete technology, which makes it difficult to identify reliable replacement costs. Furthermore, when comparable assets are not available in the local market, identification of replacement costs must consider the impact of transportation and other costs such as import duties in the derivation of a value.

Asset based methods are generally used when the enterprise is slated for liquidation and may be used as a floor price in negotiated sales and auctions. Where the enterprise is to be sold as a **going-concern**, income-based methods are more suitable.

Income-Based Methods

Income-based methods derive enterprise value in terms of the expected future performance of the firm. The most commonly used income-based method is the **discounted future cash flow method.** The discounted cash flow (or "DCF") method derives the value of the company in terms of the discounted projected future cash flows which will be realized from the company's operations. These cash flows are discounted to the present value using an appropriate **discount rate** which reflects the time value of money and its "opportunity cost.

This method is commonly used because it considers the condition of the external market, the macroeconomic and institutional environment, as well as the internal conditions of the firm such as production and management ability -- all of which are likely to be considered by a prudent investor -- in deriving company value. However, application of the DCF method can become complicated where economic transition makes the determination of an appropriate discount rate and cash flow trend less reliable.

Market-Based Methods

Two **market comparable** approaches can also be used to estimate enterprise value. The **comparable companies** approach relies upon the stock performance of companies involved in the same line of business as the target enterprise. The price per share of the comparable company is then taken as an indication of the price investors would be willing to pay for the SOE in that sector. Where a majority share of the target company is to be sold to a single or concentrated group of investors, a premium is often added to the estimated value derived through the comparable company method to reflect the added "value" of a controlling interest in the firm.

The reliability of this method depends upon the identification of closely comparable companies and trading situations. Therefore, in countries where there is minimal trading activity or no stock market, where there are no comparable companies in the domestic market, or where economic, structural, technological, or size differences weaken the comparability between the chosen "comparable" company (often an overseas firm operating in a vastly different environment) and the company to be valued, this method may be less practical.

The second market comparable approach is the **comparable transaction approach.** This method estimates the value of an enterprise in terms of the price that has been paid to acquire similar firms. Here again the reliability of the results will depend upon the comparability of the target firm, in terms of size, performance, economic and industry conditions, etc., with that of the recently transacted firm. However, where recent transactions of similar companies have occurred in the same country or region, the comparable transaction approach can provide a meaningful indication of potential investor interest, and thus the value, of the target company.

B. Issues in Valuation

<u>Transparency</u>

The valuation procedure, as a critical component of the overall privatization process, can become highly politicized. Thus it is important to maintain the transparency and objectivity of the process to the greatest degree possible. In various countries, the public has been known to criticize privatization transactions where the selling price is seen to be too low, resulting in accusations of covert dealings or ineptitude (i.e., "selling out" the state). For example, the sale of the French Elf-Aquitaine drew criticism from the socialist opposition when the initial offer price per share rose by 11 percent shortly after the floatation.[11] Conversely, in Grenada, a public offering of shares in the National Commercial Bank to local investors, even though it was priced at a 9 percent discount from the price per share paid by a Trinidadian investor group for a majority block, was criticized as being inflated.[12]

Due to the highly politicized nature of SOE valuation in privatization, policies have emerged in several countries which are politically motivated but are financially unrealistic and often counterproductive to the privatization effort. For example, in the Philippines, the Commission on Audit (COA) for the privatization program has insisted that no state asset should be sold at below its net book value.[13] However, many of these assets are overvalued such that the net book value does not realistically reflect the true market value of the assets. Fixing a sale price above or at book value in these cases can lead to bid failures and impair the success of the privatization effort.

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[11] Techniques of Privatization of State-Owned Enterprises, Volume I: Methods and Implementation, Charles Vuylsteke, page 109.

[12] See <u>Public Information Program Strategy</u>, Price Waterhouse International Privatization Group, USAID Privatization and Development Project, 1993.

[13] See <u>Technical Assistance Project to the Government of the Philippines</u>, Price Waterhouse International Privatization Group, USAID Privatization and Development Project, 1991-present.

Although it is unlikely that all parties will accept the offering price as the best price, it is important for governments to conduct transparent valuations to derive justifiable prices for their state enterprises. Many countries, including France, promote transparency and objectivity of the valuation process by appointing privatization commissions composed of independent members. They also established official procedures by which valuations are processed, reviewed, and acted upon. Similar procedures have been established to manage and monitor the valuation process in Senegal, Tunisia, and the Philippines.[14] However, these agencies must also recognize the conditions which limit the applicability of each valuation method and make realistic policies in consideration of these factors.

Private and Negotiated Sales

In the case of private and negotiated sales, the valuation process should yield a **range of values** which will serve as the basis for the negotiations process. Where only one value is provided, negotiations can become stymied due to the lack of flexibility at the bargaining table. Additionally, government must "value" concessions which may be acceptable in exchange for cash discounts. For example, agreements by target investors to maintain work force levels for a set period, train the existing work force, or to invest in other economic programs may be offered in lieu of a higher selling price. These commitments imply significant costs to the investor, thus affecting the perceived value of the target firm. It is important, therefore, that negotiation teams have a firm sense of how much such concessions are worth in relation to the derived value of the enterprise being sold.

Other considerations which may reduce the value of the firm include the existence of restrictive legislation, such as labor laws or environmental laws, which imply an automatic liability for the acquiring investor in terms of severance payments or waste clean-ups. It is quite common for the state to assume responsibility for any and all existing claims on the enterprise prior to sale. This practice is followed in the Czech and Slovak Federal Republics and Poland regarding environmental liabilities.[15] In Germany, for example, the Privatization Ministry has established a policy to address the issue of existing shareholders' claims and other significant claims against its state enterprises prior to valuing and offering the enterprises for sale (See Chapter VII of this report).

C. Pre-Qualification of Potential Buyers

Pre-qualification of potential investors is performed for private and negotiated sales. The purpose of this process is to guarantee the commitment of the investor to meet certain conditions

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[14] See Vuylsteke, op. cit. p. 112.

[15] Based on conversation with Pierre Guislain of the World Bank.

of sale prior to the bidding process. Bidder pre-qualification is commonly used for the following reasons:

- To ensure technology transfer and/or investments following the privatization.

- To guard against company dissolution following the privatization. By attracting qualified, financially-strong investors, governments can protect the future of strategic state enterprises.

- To ensure compliance with provisions which preclude sale to foreign investors.

- To satisfy political objectives which seek to reduce the concentration of wealth among specific groups.

- To limit initial inquiries to serious investors only. In many cases individuals may request sales documents out of curiosity or because they are competitors of the firm being privatized.

There are a number of different methods which have been used by countries undergoing privatization to pre-qualify bidders for target enterprises. The method used will be a function of the objectives and conditions of the pre-qualification. Among the observed methods are the following:

- Requiring investor consortiums to include a technical partner that has significant experience in the operation and maintenance of companies in the same or similar lines of business. This was the case in the privatization of Telmex where the Mexican government required that the bidding consortiums include a foreign operator with extensive telecommunications experience.

- Restricting sales to nationals or certain ethnic groups or requiring (majority) interest by nationals or certain ethnic groups in investor consortiums. For example, in the Philippines, the privatization of land is restricted to local investors, and the sale of strategic companies and/or companies with natural resources must be structured such that foreign interests do not exceed 40 percent with local interests representing 60 percent.[16]

- Requiring investors or consortiums led by investors who are in the same line of business. This qualification is commonly used to prevent "fire sales" of company assets by investors not interested in the continuing operation of the enterprise. For example, when the Chilean Telecommunications Company (CTC) was purchased by Alan Bond, an

[16] See Technical Assistance to the Government of the Philippines, Price Waterhouse International Privatization Group, USAID Privatization and Development Project 1991 to present.

Australian industrialist, Mr. Bond quickly sold his interest in the company for a huge profit. CTC was eventually acquired by Telefonica de Espana, an experienced telecommunications operator, after which the performance of the company was improved.

- Restricting sales to financially sound investors who will be able to run the company and follow the mandated investment program (if any). The consequences of selecting financially unsound investors for privatizations was experienced during the first wave of Chilean privatizations in the mid-1980's. Many of the strategic enterprises privatized had to be re-nationalized when it became evident that they would go bankrupt if not rescued. This restriction is widely applied in cases of privatization involving regulated industries such as telecommunications, power and transportation, where the performance of the company and the quality of its service impact the general population.

- Selling information memoranda, prospectuses, or other confidential sales documentation at medium to high prices (generally a deposit refundable to unsuccessful bidders or credited against the purchase price for the winning bidder) to restrict inquiries to only serious investors. The prospectus for the sale of ENTEL, the Argentine telephone company, for example, was sold for several thousand dollars.

- Imposition of strict investment programs to be implemented post-privatization. For the privatization of the commuter rail lines in Argentina, the Government selected bidders based upon their ability to implement an intensive 15-year investment program after the privatization. The bidders also had to fulfill particular performance requirements such as improving the service and reducing travel time.

Therefore, bidder pre-qualification can be applied in pursuit of a number of objectives. Pre-qualification allows governments to establish additional non-price related sales criteria.

D. Lessons Learned on Valuation and Bidder Pre-Qualification

1. There are three general approaches to deriving company value: **asset-based, income-based, and market-based methods.** Asset-based methods, which take enterprise value to be solely a function of the worth of the tangible assets are generally used when enterprises are to be liquidated. Income-based methods which consider the earnings potential of the company and market-based methods which compare the performance of the target firm with that of firms in the same or similar lines of business are generally used when the enterprise is to be sold as a going concern.

2. The objectives of the government undergoing privatization, the availability and reliability of financial and operating data, and the condition of the enterprises are the key factors which determine the appropriate valuation method.

3. Transparency of the valuation process is very important in preserving the integrity of the privatization. Many countries establish committees to manage the valuation process and evaluate the results.

4. Enterprise valuations should result in a range of values for the company. When the privatization method involves a private or negotiated sale, the range should reflect the effect of incorporating alternative terms of sale. For example, a pure equity value will be higher than the offer price of the enterprise if an employment guarantee is obtained, or if the company liabilities are left on the books, or if an investment plan is imposed. Because certain terms can be very important in realizing the privatizing government's economic objectives, the "value" of these terms must be considered in pricing the enterprise.

5. Governments must consider the impact of existing claims or regulatory requirements on the value of the company. These obligations often result in automatic liabilities to the successful investor. To the extent possible, therefore, it is preferable to remove these liabilities from the enterprise to preserve the selling price. Additional consideration must be given to investment requirements and other guarantees or concessions which may be offered in exchange for lower asking prices.

6. Bidder pre-qualification can be an important step in ensuring compliance with non-financial selling criteria which are important to the success of the privatization and the future of the enterprise.

IV. FINANCIAL MARKETS AND ALTERNATIVE FINANCING INSTRUMENTS

ISSUE: To support privatizations, various financing mechanisms have been utilized in developed and developing countries to mobilize sufficient resources through the financial markets. What are the major issues in selecting and utilizing these financing instruments?

A. Major Financing Instruments Utilized

The major financing instruments used in mobilizing resources through the financial markets for privatization include: (i) **public flotations; (ii) bond financing; (iii) debt-equity swaps; and (iv) investment funds.**

Public Flotations

Public share offerings are the most commonly used method of disposing state-owned companies in developed countries, as in the cases of the largest British SOE divestitures. Public flotations are less common in developing countries. Nonetheless, in developing countries where capital markets are sufficiently organized and developed, public flotations offer a few key advantages:

- They permit widespread shareholding, allow broader resources of the general investment public to be targeted, and are usually characterized by openness and transparency.
- Their openness and wide accessibility help overcome the objection that government assets may be transferred to wealthier individuals in the country.
- If the privatization is successful and share prices rise, it serves to create a constituency which will prevent the reversal of the privatizations accomplished, and well as support future privatizations.

Chart 4.1 in the following page shows some of the steps that will be required for a public offering of shares. Following that, Box 4.1 illustrates the key steps necessary for a successful share sale which was organized in Jamaica in 1986.[17]

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[17] See Reforming Financial Systems: Policy Change and Privatization, by Zank, Mathieson, Nieder, Vickland, and Ivey, Greenwood Press, 1991.

Chart 4.1

TASKS REQUIRED FOR SHARE SALES

- ✔ CONDUCT AUDIT OF FINANCIAL POSITION
- ✔ ASSESS COMMERCIAL PROSPECTS
- ✔ RESTRUCTURE BALANCE SHEET/TRANSFER LIABILITIES
- ✔ DESIGN PROTECTIONS FOR MINORITY SHAREHOLDERS
- ✔ PREPARE PROSPECTUS
- ✔ SET PAR VALUE AND ISSUE STOCK
- ✔ PROMOTE AND MARKET SHARE SALE
- ✔ TRANSFER STOCK TO EXECUTING AGENCY
- ✔ IMPLEMENT STOCK SALE

SRI International®

Box 4.1

The Privatization of the National Commercial Bank in Jamaica

The successful privatization of the National Commercial Bank (NCB) in Jamaica in December 1986 illustrates the importance of many of these steps in planning and implementing share sale. From the outset, the strategy for privatizing NCB was to utilize a public share offering of 51 percent of the bank's shares. The offering involved market valuation, dissemination of prospectuses, a marketing plan, and a time-bound period for the offering to take place. Some of the specific steps in the preparation of the public flotations included:

- *Stock Transfer and Capital Injection:* The shares of NCB were transferred from the office of the Account General to the National Investment Bank of Jamaica, and fresh capital was injected to improve the bank's capital/asset ratio.
- *Prospectus Preparation:* The privatization team prepared a comprehensive prospectus, 170,000 copies of which were distributed throughout the country.
- *Share Pricing:* The privatization team first evaluated the past and prospective financial performance of NCB, using the private Bank of Nova Scotia (BNS) as a comparative benchmark. They then proceeded to set the share price at a discount from that derived from the BNS price formula. This pricing method ensured the competitiveness of the NCB shares and provided clear incentives for potential shareholders.

Source: Zank Reforming Financial Systems: Policy Change and Privatization, by Zank, Mathieson, Nieder, Vickland, and Ivey, Greenwood Press, 1991.

Despite their political appeal, public share offerings have seldom been used in developing countries because capital markets are thin and SOEs are often in conditions too poor to be suitable for stock market flotation. There have been exceptions, however. For example, shares of well known and profitable SOEs, including financial institutions and telecommunications companies, have been successfully sold in Jamaica (see Box 4.1), Chile, Nigeria, and the Philippines.[18]

Bond Financing

Although the decision to borrow for purposes of acquiring government assets or making new investment essentially rests with the purchaser, the availability of credit could be critical in determining whether the privatization transaction can proceed. For long-term financing of privatization transactions, investors in developing countries have mostly relied on the banking sector, especially in the cases where the bond markets are not very well developed.

However, medium- to long-term debt instruments have been successfully utilized, even in developing countries, to mobilize resources in the financial markets to finance the purchase and/or the additional investment necessary to carry out restructuring of newly privatized enterprises. Although bond financing to finance privatization transactions usually entails higher transaction costs compared to direct borrowing from banks, it allows the buyer to tap into the liquidity of a wider market which include small individual investors and institutional investors. The bond market in developing countries is usually deeper and more developed than the stock market. For example, in many countries where the stock market does not exist, there is still a market for trading domestic treasury bills and commercial and other debt papers. Bond financing also offers investors the advantage over equities of more stable returns and seniority in debt collection. Thus, it can be advantageous to tap into financial resources available in the bond markets.

See Box 4.2 for a success case in leveraged buy-out of a tire company in Sri Lanka using bond financing.[19]

Debt-Equity Swaps

Debt-equity swaps are privatization financing mechanisms whereby the debt holder interested in buying the enterprise swaps debt worth a fraction of its face value in the secondary market for equity, usually at a price somewhat above the usual secondary market price. Swaps can help to reduce financing constraints and improve a country's investment climate.

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[18] See Privatization: The Lessons of Experience, by Kikeri, Nellis and Shirley, the World Bank, 1992.

[19] "Kelani Tyres: An Innovative Case of Privatization", SRI International, for AID/Bureau of Private Enterprise/Office of Investment, 1993.

Box 4.2

The Privatization of Kelani Tyres in Sri Lanka

Kelani Tyres Limited was among the first batch of government companies selected to be privatized under Sri Lanka's current privatization program. The divestiture was carried out according to a "60-30-10" formula, whereby a majority shareholding of 60 percent is divested to corporate investors through competitive bidding, 30 percent is offered to the public, and 10 percent is distributed to the employees. (See Figure 4.1 for the financing arrangement of the privatization).

In March 1992, a group of local investors purchased a 60 percent shareholding of Kelani Tyres, half of the costs of which was financed through the issuance of six-year debentures. While leveraged buyouts involving partial bond financing are common in countries with well-developed bond markets, the issuance of medium-term debentures to finance a privatization transaction is extremely uncommon in many developing countries, such as Sri Lanka. Local investors were not familiar with bonds with medium or long term maturities, since the longest Treasury Bill has a maturity of only one year.

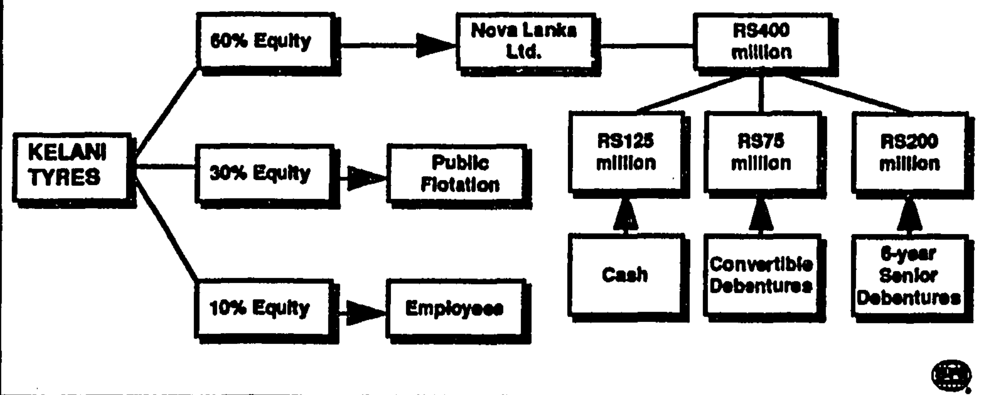
To reassure skeptical investors of the viability of a new debt instrument, a consortium of several local banks provided a guarantee on the debentures, without which investors would have preferred to keep their funds in relatively risk-free Treasury Bills, despite their lower yield. In addition, USAID provided a partial guarantee to the debentures through its Privatization Guarantee Program, which was critical in helping the underwriters to reduce their risks.

The Kelani privatization is widely believed to have a positive impact in the development of the financial market in Sri Lanka. The successful flotation of medium-term debentures has served to enhance the ability of financial institutions to raise domestic capital to finance upcoming privatizations in Sri Lanka. The transaction serves as a useful model by demonstrating that long-term private capital can be mobilized through the introduction of a new debt instrument, by means of innovative financing arrangements.

Source: "Kelani Tyres: An Innovative Case of Privatization", SRI International, for AID/Bureau of Private Enterprise/Office of Investment, 1993.

Figure 4.1

The Privatization of Kelani Tyres



Debt-equity swaps have proven to be useful in attracting additional investors, including foreign commercial banks, to transactions that might have otherwise fallen through.[20] A substantial proportion of the swaps under privatization have involved the original commercial bank lenders. An example is the privatization of the state-owned telecommunications company in Argentina in November 1990, in which the SOE was sold for $214 million in cash with a $2 billion reduction in the face value of its debt. It was widely believed that the transaction, in particular the buyer's pledge of $5 billion in capital improvements over ten years, would not have materialized without the swap, which induced the participation of commercial banks.

Some critics of debt-equity swaps argue that governments may receive more value for their SOEs by selling the enterprise and using the proceeds to repay or repurchase the debt at the prevailing secondary market prices. In the case of Mexico, most of the SOEs were sold without swaps and the proceeds are being used to buy back debt. Nonetheless, it is important to note that compared to many other heavily indebted countries, Mexico is more likely to interest potential investors as the result of the debt reduction negotiated under the Brady plan. Many other debtor countries face fewer options, and a large debt overhang may deter investors from buying SOEs, especially when large amounts of new investments are required to restructure large companies. Under such circumstances, debt-equity swap can be a useful tool to accomplish the dual objective of privatization and debt reduction (See Box 4.3 below for a case study of debt-equity swaps in Chile).

Countries may be able to increase their access to swaps by creating conversion funds for privatization. These funds, which have been successfully used in Argentina, Chile, and the Philippines, pool eligible debt paper from commercial banks, multinational investors, and individual investors to swap for enterprise assets.

<u>Investment Funds</u>

Investment funds are envisioned as playing an increasingly important role in the privatization process in Eastern European countries, especially in the mass privatization programs. However, due to the special circumstances and needs of these countries, the financial instruments that have emerged do not necessarily fit the models most frequently used in industrialized countries.[21] Classic open-end funds in OECD countries, such as mutual funds, are designed for small investors and are usually regulated to minimize risks to protect investors. Given the risky nature of SOEs undergoing privatization and restructuring in an uncertain environment, classic open-end funds are not likely to play an important role in the privatization process in Eastern Europe.

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[20] For a more detailed discussion, see Chapter 4 in Kikeri, Nellis and Shirley, <u>op. cit.</u>, p. 43.

[21] See "The Role of Investment Funds in the Privatization Process" in <u>Trends and Policies in Privatization</u>, Vol.1 No.1, OECD Publications, 1993.

Box 4.3

Case Study: Debt-Equity Swaps in Chile

The debt-equity swap program from 1985 to present is one of the most successful in the world. The program's objectives are to reduce external debt, attract new foreign investment, and encourage the repatriation of Chilean capital held overseas. Several factors have contributed to its success:

- Clear-cut swap rules were established in Chapters XVIII and XIX of Chile's Compendium of Rules on International Exchange, which respectively allow the conversion of foreign debt into a peso obligation, as well as equity investment by foreigners via debt cancellation. The consistent implementation of the established rules in Chile, compared to the occasional suspension or modification of conversion programs in other countries, was viewed as critical to Chile's success in inducing continued interest from potential investors in debt swaps.

- The debt conversion program in Chile has been carefully designed and implemented. A monthly quota for the use of Chapter XIX allows the Central Bank to ration approvals to control the exchange rates and inflationary effects of swaps. Stringent limits have been enforced on repatriation of profits and capital derived from the investment made. The program design has also reduced the opportunity for investors to take funds abroad and bring them back through swaps to maximize gains.

- Unlike the debt conversions in Argentina, Brazil, and Mexico, where the central banks would place the value on external debt conversions, it was the capital market in Chile that performed this task and created the possibility for intermarket arbitrage. Chile's stable and supportive macroeconomic policies since the mid-1980s, its well-developed, liquid capital market, and the free-market design if its swap program were critical in raising confidence and attracting long-term investment interest from both Chilean and foreign investors.

Between 1985 and 1991, two swap schemes retired about $7 billion in commercial bank debt, or 30 percent of the total commercial bank debt. The pace of conversion under Chapter XIX fell off sharply in 1991 as the secondary market price of eligible debt rose to 90 percent of the face value and the discounts on the declining debt stock became increasingly limited.

Source: Privatization and Development, Hanke (ed.), International Center for Economic Growth, 1987.

On the other hand, the closed-end funds such as venture capital funds, which are set up with the special purpose of simultaneously providing equity capital, entrepreneurial skills and some degree of enterprise control, probably come closer to meeting the needs of privatizing SOEs. Most of the investment funds that have been established so far in the context of privatization programs in Eastern Europe operate as closed-end funds. In former communist countries, however, there is often an additional need to transfer share ownership to the public through the creation of investment funds. Thus, the investment funds that emerged in several Eastern European countries, notably Poland and Romania, were a hybrid serving several functions:

- Transfer ownership to large segments of the population in the severe shortage of private savings.

- Perform a leading management role in the privatized firms.

- Raise capital restructuring of privatized firms.

These closed-end funds, however, differ from their counterparts in industrialized countries in some important respects. In OECD countries, venture capital funds typical draw large institutional investors or large companies seeking investments with high-risk and high-return characteristics. The amounts these investors place in such venture capital firms are usually small in relation to their total portfolios. On the other hand, those who hold shares in the investment trusts in Easter European countries are generally small, first time, and unsophisticated investors who nonetheless are acquiring shares essentially free of charge.

In addition, most of the investment funds in industrialized countries, especially the open-end funds, are not significantly engaged in corporate management other than participating in annual shareholder meetings and issuing analytical reports on management decisions. In Eastern European countries, however, investment funds are specifically asked to play the primary management role in privatized firms in the absence of a trained managerial class, as in the case of Poland. The hybrid nature of investment funds stems from the need to spread the ownership of economic assets among the public while simultaneously minimizing the negative impact of a dispersed ownership.

However, concern has been expressed over the potential conflict of interest among the fund managers who have to balance the need for maximizing profits for the shareholders as well as carrying the much-needed enterprise restructuring that might depress short-term profits. Furthermore, there is risk that corporate control by government-organized investment funds may not be sufficiently market-oriented, and that investment funds could become yet another group of entrenched bureaucracies with corporate control becoming tantamount to political control.

Given the high-risk nature of the venture capital-type investment funds operating in an uncertain environment in countries undergoing privatization, some degree of regulation on investment funds will be necessary to safeguard the interest of small and inexperienced shareholders. The Czech Republic has enacted a new Law on Investment Funds in April 1992 which is aimed at enhancing investor protection. Under the new law, investment funds are prohibited from owning more than 20 percent of one firm, and each investment fund is required to invest in a minimum of ten firms. The critical issue here is the appropriate degree of regulation required to balance the need to protect small investors without impeding effective corporate governance in newly privatized enterprises.

Investment funds are envisioned to play an expanding role in the privatization process in Eastern Europe. However, due to the lack of proper systems for clearing and settlement of securities in the context of underdeveloped capital markets, the investment funds are not expected to attract large-scale institutional investment both domestically and overseas in the short term. Furthermore, domestic private savings are currently too small to provide any meaningful financial resources to the investment funds to support the privatization process.

B. Lessons Learned from the Use of Alternative Financing Instruments

1. Public flotations encourage widespread shareholding, and facilitate distribution of wealth, thereby helping to diffuse political opposition. As such they serve to create and expand a constituency which will support privatization.

2. Privatization through public flotation requires careful planning and execution in the areas of balance sheet enhancement, pricing of shares, prospectus preparation, information dissemination and marketing, and retail distribution. Public flotations are most appropriate for larger, more profitable SOEs.

3. Medium-term debt instruments can serve to mobilize private domestic capital to finance privatization even in countries where the capital markets are rudimentary and underdeveloped. However, issuing debt instruments involves high transaction costs and is thus more appropriate in cases where large sums of money have to be raised.

4. Local financial institutions in developing countries can become active partners in financing the privatization process if they are allowed to reduce their risk exposure to a single privatization venture.

5. In countries where large debt overhangs would significantly deter investors from buying privatized SOEs, debt-equity swaps can serve the dual objective of privatization and debt reduction, thereby enhancing a country's investment climate.

6. Consistent implementation of clear-cut rules and a set of stable and supportive macroeconomic policies are critical to the success of debt-equity swap programs.

7. The investment funds currently being established in the Eastern and Central European countries are often hybrids designed to achieve capital transfer to the public at large and perform a leading management role in the privatized enterprises.

8. Given the high-risk nature of the venture capital-type investment funds operating in an uncertain environment, some degree of regulation is essential to safeguard the interests of small and inexperienced shareholders, without imposing unnecessary bureaucratic control that impedes effective corporate governance.

V. POLICY AND REGULATORY REFORMS

ISSUE: Key pclicy and regulatory reforms have been introduced in conjunction with many countries' privatization programs. What are the principal areas of policy, regulatory, and legal reforms which would complement the privatization process and what lessons have been learned from their implementation?

A. Principal Regulatory, Legal, and Policy Reforms

Since privatization means significant changes in the ownership structure of certain sectors of the economy, its usually requires substantial regulatory and legal modifications to accommodate those changes. Overall, it is critical that the policy environment encourage competition and minimize price distortions in order for privatization to have a positive and lasting impact on a country's economic situation. Some of the key **legal, regulatory,** and **policy reform** issues related to privatization are discussed in this section.

Legal and Regulatory Reforms

Since legal issues permeate the entire privatization process, a well-functioning **legal framework** is especially critical to success in privatization. The legal foundation for privatization is framed by various aspects of business legislation (property law, antitrust law, corporate law, dispute settlement, environment legislation, etc.), defining or confirming property rights, modifying the legislation of SOEs to be divested, and developing laws for organizing the privatization process.[22]

Prior to privatization, existing legislation and the legal status of the SOEs should be assessed as to whether they could accommodate the goals of privatization. In many countries, for example, SOEs cannot be privatized in their existing legal form. Legal restructuring may range from simple amendments to the articles of association to the dissolution of an enterprise and transfer of its assets and liabilities to a new corporate entity. In the case of a public offering, a number of specific steps may required to convert the SOE into a public limited liability company. British Telecom, for example, was transformed from a public corporation into a public limited company before it was privatized.

Legal reforms may also be required to clarify the rights and responsibilities of the parties involved with respect to the assets and liabilities of the SOE being privatized. This is especially important in cases where liabilities may significantly affect the valuation of an enterprise (e.g. when the environmental degradation caused by the SOE's operations requires significant clean-up

[22] Divestiture of State Enterprise: an Overview of the Legal Framework, Pierre Guislain, World Bank Technical Paper Number 186, 1992.

costs). Furthermore, following completion of a privatization transaction, legal safeguards are required to ensure that all parties comply with the terms of the privatization agreements and to develop effective mechanisms to enforce compliance.

The establishment of a **sound regulatory framework** to oversee monopolies as well as to promote competition is an important part of the privatization process. In many countries, particularly developing countries, state ownership of certain sectors such as public utilities has made it possible to sidestep the need to regulate them as closely as private ownership would require. Public ownership of monopolies has, to a certain extent, mitigated the potentially sensitive issue of monopoly profits versus consumer welfare.

In the case of privatizing a **natural monopoly**, regulatory controls will have to be established to safeguard the interest of the general public, both in the standard of the services provided, and in the prices charged by the private company. This will generally require the establishment of special regulatory bodies, such as the public service commissions which operate in each state in the United States. These regulatory commissions oversee utilities including gas, electricity, and the telephone companies. Profits made by these monopolies may be limited to a certain level of return on invested capital (e.g. 12 percent for most public utilities in the U.S.), or by linking the price of services to inflation (e.g., prices charged by the British Telecom). The regulatory bodies may also encourage cost reduction by allowing higher profits on the basis of declining operating costs.

In some cases, the regulatory framework for a particular monopoly has been incorporated into the privatization transaction agreement. In Venezuela for example, the congress did not pass the law in time to create a new regulatory framework and agency for the privatization of CANTV (the telecommunications company). As a result, the bulk of the regulatory framework was incorporated in the privatization agreement with CANTV, and a decree was passed by the government to establish a regulatory agency to provide regulation and oversight in the interim.

In general, **privatizing SOEs that operate as natural monopolies is more difficult than privatizing firms in competitive markets** because the enterprises are larger, the stakes are higher, foreign investment issues are more salient, and capital markets are thin.[23] Nonetheless, privatization of enterprises in noncompetitive sectors has yielded benefits in developing countries including Chile, Malaysia and Mexico, where the policy environment was favorable and the government had the capacity to introduce or strengthen the regulatory framework.

In **noncompetitive sectors**, privatization often requires the deregulation of monopolies and the introduction of **antitrust** legislation to reduce barriers to entry and encourage competition. In Chile, the state-owned electricity generation and distribution utility was broken up, starting in 1985, into several smaller corporations, as a preliminary step towards its privatization. In another example, British Telecom, which had the authority to grant licenses

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[23] See Kikeri, Nellis, and Shirley, op. cit.

under its telecommunications monopoly prior to its privatization, had these powers subsequently revoked.

Box 5.1 below shows the regulatory reforms undertaken by the Chilean government before the privatization of Banco de Chile.

The degree to which the company will be regulated after privatization will directly affect its valuation, as more stringent regulation or lower protection from competition mean lower profits, and lower share prices. The proper sequencing of regulatory reform and privatization is thus critical. In order to determine the price they are willing to pay, investors need to know under what regulatory regime the company will be operating in the future. A transparent and stable regulatory framework clarifies the rules of the game and creates a stable and predictable operating environment for private investors.

Policy Reforms

Experience in many countries has demonstrated that privatization has created "more efficiency" gains in countries in which it is part of a broader macroeconomic reform program aimed at improving the business operating environment. Policy reforms to ensure competitive markets in the areas of **pricing, capital markets, trade, investment, taxation,** and **labor** are all important in maximizing efficiency gains from privatization (See Figure 5.1).

Clearly, not all of these policies can be adjusted at once, nor should privatization be delayed until all the market imperfections have been eliminated. Private enterprise development and policy reform should be built into the privatization process in an iterative way. Privatization should be used as a catalyst for future reform in these areas.

The major areas of commercial policy reforms that will complement the privatization process are summarized below.

Pricing Policies. In competitive sectors, market prices are essential for achieving efficiency. Without the freedom to set prices, few investors would be interested in buying SOEs. Furthermore, if the SOE is sold at a lower price which reflects the effects of price controls on future profits, subsequent price liberalization might result in a windfall gain for the investor and accusations of selling the SOE below its value. Thus, proper sequencing of price liberalization and privatization is important, especially in countries with heavy price controls such as India, and East and Central European countries in 1990-91.

In noncompetitive sectors (such as natural monopolies), a special regulatory framework may have to be set up to provide a certain degree of oversight in order to protect the public from monopoly pricing and substandard services, as discussed above.

Box 5.1

Regulatory Reforms Prior to the Privatization of Banco de Chile

Before the public offering of shares of Banco de Chile in 1985, the government took several critical steps to regulate the activities of and introduce competition in the financial system. These steps included:

- Major reform of the banking laws and practices, increasing the role of the regulatory agency for the banking sector;
- Curtailment of the diversification of activities by banks;
- Financial restructuring of the Central Bank through long-term refinancing of bad debts;
- Introduction of new financing mechanisms for bank debtors through the Central Bank; and
- Major reorganization of the banks, with important divestitures in some areas.

Since the privatization, new competition among privately-owned financial institutions in Chile has resulted in a wide variety of instruments available to savers. The Chilean financial market currently consists of a large number of competing private institutions. Of the five types of institutions – official institutions, commercial banks, investment banks, development banks, and other financial intermediaries – commercial banks are by far the most important player. Currently over 20 foreign banks serve the Chilean market.

Source: "Chile: Techniques of Privatization" in Techniques of Privatization of State-Owned Enterprises, Vol. II: Selected Country Case Studies by Helen Nankani, World Bank Technical Paper 98, 1988.

Figure 5.1

POLICY AND REGULATORY REFORMS TO COMPLEMENT PRIVATIZATION

Policy Area	*Policy Reform Measures to Accompany Privatization*
Legal Framework	**Modify status of SOE; clarify rights and responsibility of parties involved; institute legal safeguards to ensure compliance.**
Monopolies Control/Competition	**Deregulation of monopolies; introduction of antitrust legislation and regulatory controls for natural monopolies.**
Pricing	**Decontrol prices in competitive sectors; maintain price/or cost control measures for natural monopolies.**
Capital Markets	**Strengthen capital markets; introduce legislation favorable to development of stock market, and other financial instruments.**
Trade	**Reduce trade barriers and promote free trade to encourage efficiency.**
Investment Regulation	**Harmonize privatization laws and procedures with Investment Code; remove barriers to foreign investment.**
Taxation	**Introduce transparent and uniform tax system; reduce unduly high taxes.**
Labor Market	**Allow companies greater flexibility in hiring, firing and setting wages.**

Major Policy and Regulatory Reforms that should be emphasized for privatization

Policy Reforms to complement privatization

SRI International ®

Capital Market Policies. Well-functioning capital markets greatly facilitate the privatization process by providing many financing options. However, the lead time required to establish functioning capital markets is normally too long to be able to create them in time to serve as a major vehicle for financing privatization. A useful first step would be to develop basic securities legislation regulating the issuance and trading of shares, the development of financing instruments, as well as the operations of financial intermediaries (banks, brokers, etc.).

In some countries, capital market reforms have been introduced to encourage the participation of institutional investors in the divestiture process. In Chile, legislation governing pension funds was amended in 1985 to allow pensions funds to invest in company shares. Similarly, regulations in Singapore governing the use of funds withdrawn from the pension fund (the Provident Fund) were modified to allow for investment in state-approved securities.[24]

Trade Policies. Low or moderate external protection (tariff, quotas, etc.) fosters import competition and encourages efficiency. Buyers of SOEs, however, often try to negotiate general or special trade protection from competing imports as part of the settlement to ensure protection of their profits. Exemption from provisions of existing trade legislation is not recommended because it runs counter to one of the principal objectives of privatization - enhancing economic efficiency. If it cannot be avoided, it should be granted in a transparent fashion and factored into the evaluation of offers.

If privatization was undertaken as part of an overall liberalization program under which trade protection will be dismantled, trade reforms should proceed privatization. The loss of trade protection may significantly affect the projected profits and hence the value of the SOE. The failure to coordinate trade liberalization with privatization may cause an instant reduction of the value of the privatized enterprise and unfair damage to its buyer when trade policies are implemented.[25]

The privatization process in Sri Lanka in the 1980s, for example, was an integral part of government's program to increase market efficiency and improve the performance of the economy. Its liberalization program encompassed the reduction of subsidies, abolition of exchange controls, major adjustment in trade and exchange rate policy, all of which represented a fundamental shift towards a more market-oriented economy.

Investment Policies. The investment policy regime is critical to attracting buyer to invest in the SOEs. Investment regulations issues relevant to privatization are examined in detail in Chapter X of this report. In general, clear, transparent, and nondiscriminatory investment laws, and the freedom of profit and capital repatriation are major concerns to potential buyers

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[24] See Guislain, op. cit..

[25] See various country case studies, Nankani, op. cit..

of SOEs. Privatization laws and procedures should be harmonized with existing investment codes, and barriers to foreign investment should be reduced.

Taxation. A transparent and consistent tax system is needed to encourage adequate private investment in former SOEs. Investors buying SOEs are interested in the after tax profits of the enterprises and the consistency of tax administration and enforcement. If taxes on profits and capital gains are exceptionally high, steps should also be taken to lower the marginal rates in order to encourage investment in the SOEs. See Box 5.2 for information about the tax reforms in Jamaica.

Labor Market Policies. Labor laws are important to privatization because they may affect the investor's ability to set wages and benefits, hire and fire workers, and manage his work force. Excessively stringent labor laws which restrict those freedoms may reduce the viability and attractiveness of SOEs to be privatized. In Brazil, the president of the BNDES (the agency in charge of coordinating the Brazilian privatization program) has identified rigid labor laws and the resulting high labor costs as one of the major impediments to privatizing SOEs in that country.

Since labor redundancy is prevalent in SOEs in many countries, downsizing the work force is often an essential first step in the restructuring of privatized enterprises. In Germany, for instance, where labor laws on lay-offs are quite restrictive, the parliament granted buyers of privatized enterprises a temporary exemption from these restrictions in order to facilitate the country's privatization program. In general, a flexible approach on the treatment of existing labor in the SOEs will better accommodate the privatization process than the rigid application of existing labor laws.

B. Lessons Learned from Legal/Regulatory/Policy Reforms

1. Legal issues permeate the whole privatization process. Thus, it is imperative that an appropriate legal framework be established to facilitate privatization.

2. To safeguard the interest of the consumers, the proper regulatory framework may have to be established or modified to accommodate the new status of privatized enterprises.

3. Since the regulatory framework will affect the profit of the privatized SOE, the proper sequencing of regulatory reform and divestiture is critical to arriving at a fair price for the SOE.

4. SOEs functioning in competitive environments or in markets easily made competitive are better candidates for privatization. Their sale is simple compared with that of public monopolies, and they require little or no regulation.

Box 5.2

Tax Reforms in Jamaica

Jamaica has undertaken comprehensive reforms in its tax system since it has begun its privatization program in the mid-1980s. Four amendments were particularly relevant to promote equity investment and to encourage participation in the privatization process.

(1) Taxes were introduced on interest income for the first time, encouraging many to shift their savings away from banks accounts towards the stock market.

(2) The corporate tax rate was reduced from 45 to 33.3 percent, increasing the after-tax profits and the overall value of most business enterprises.

(3) Taxes on stock market transactions and share issuances were eliminated, stimulating the development of the capital markets.

(4) To encourage re-investment, the Government of Jamaica introduced tax credits for the conversion of dividends into equity shares in 1988.

These measures were viewed as critical in improving business performance and propelling capital market development in the 1980s.

Soruce: "Privatization in Jamaica: Two Case Studies" by Roger Leeds, Center for Business & Government, Harvard University, 1987.

5. An appropriate regulatory framework must be in place before monopolies are privatized. Failure to regulate properly can harm consumers and reduce public support for privatization.

6. Privatization has a greater chance of success if it is undertaken in a business-friendly commercial policy environment. However, privatization should not be delayed until all the market imperfections have been eliminated.

7. Policy reforms to ensure competitive markets in the areas of pricing, trade policy reform, and flexible labor market policies are all needed in order to maximize efficiency gains from privatization. Not all these policies can be adjusted at once, however. Policy reform can be built into the privatization process in an iterative way.

VI. TECHNIQUES FOR ENCOURAGING LOCAL OWNERSHIP

ISSUE: Governments have employed various techniques to encourage local participation in the privatization process. Based on the experiences of different countries, what are the most common and most effective strategies for ensuring widespread local ownership?

A. Principal Techniques for Encouraging Local Ownership

The promotion of wide share ownership among both employees and the general public has been a major objective of the privatization programs in several countries. The United Kingdom trebled the number of company shareholders through privatizations, while France's goal was to quintuple it and spread ownership so widely that companies cannot be re-nationalized. Several mechanisms have been employed to encourage widespread share ownership: **(i) employee discounts and employee stock ownership plans (ESOPs); (ii) individual shareholdings restrictions and share allotment plans; (iii) special incentives; (iv) voucher systems; and (v) extensive publicity and promotion.**

Employee Discounts and Stock Ownership Plans

Not only is active **employee participation** important in the expansion of local ownership, but it has proved to be critical to the overall success of privatization in many countries. While labor is usually opposed to privatization, in principle, due to the potential negative effects on employment, generous incentives and special employee stock ownership programs are often effective in diffusing labor opposition and, in some cases, winning over labor to support the overall privatization process.

Various techniques have been employed to encourage employee participation in privatization. One that is becoming increasingly common is to reserve shares for employee participation, providing incentives such as special discounts to increase interest among employees. As a standard feature in all of France's privatizations through public offerings, 10 percent of the shares were reserved for the employees who can purchase them at a 5 percent discount, or at a 20 percent discount if they hold them for at least two years. In the privatization of the National Commercial Bank in Jamaica, an elaborate scheme was established for employee stock purchases, under which each employee was entitled to acquire up to 2,070 shares at a discount or on first priority (See Table 6.1 below).[26]

[26] For a more detailed discussion see Privatization Marketing Handbook, Center for Privatization publications, Occasional Papers Series 1, March 1990.

Table 6.1

Employee Shares Scheme
National Commercial Bank of Jamaica

Shares	Minimum Purchases	Price
20 Free Shares	20	Free
350 Matching Shares	50	1 Free for each share purchased at offer price
850 Discounted Shares	50	10% discount on the offer price
850 Priority Shares	50	Offer Price
2070		

Source: Techniques of Privatization of State-Owned Enterprises, Volume 1, World Bank Technical Paper Number 88, 1988.

Frequently, a major obstacle to increasing employee stock purchases is the lack of capital among workers. Thus, the key to broadening employee stock ownership is to increase their access to credit. Some of the **Employee Stock Ownership Plans** (ESOPs) have systematically provided employees with capital through the establishment of a legal entity which provides credit for share purchases and allocate shares to the employees. This approach was successfully used in the privatization of the Alexandria Tire Company in Egypt - the first known privatization utilizing an ESOP component in a developing country.

In other cases, employees have been entitled to use their retirement funds to purchase shares of privatized enterprises. In Chile, for example, employees can advance up to 50 percent of their retirement funds in a combination of shares and cash, or alternatively could use their retirement savings as collateral for a loan to purchase shares. The interest rate for this type of loan was usually below the going market rate.[27]

[27] See Chapter 2 in Nankani, op. cit..

Individual Shareholdings Restrictions and Share Allotment Plan

To prevent the concentration of shares in the hands of a few individuals or institutions resulting from a public offering, some governments enact general investment or special privatization laws which **restrict individual shareholdings**, as in the case of Nigeria (Nigeria Enterprise Promotion Act of 1977). Such legislation may be appropriate under certain circumstances where the diffusion of ownership is a major goal in the privatization process.

Chile enacted special legislation in 1986 requiring that at least 50 percent of the shares in privatized enterprises be held by shareholders who own no more than 10 percent of the total, and at least 15 percent of the shares should be owned by 100 or more independent investors. In Senegal, the Law on Privatization mandates the Minister of State Participation to specify in each privatization the maximum number of shares allowed to be owned by one investor or a group of investors.

In other cases, however, such limitations have proven to be counterproductive and cumbersome, especially when applied to non-strategic enterprises for which the government wants the flexibility to sell larger blocks of shares. Thus, more often the restrictions on individual shareholdings are determined in a case-by-case or on industry or sector basis. In Korea, for example, maximum equity holdings are pre-specified in the privatization of all national commercial banks.

In several Asian and African countries where governments have to be sensitive to the ownership distribution among ethnic groups, a certain percentage of the shares are often reserved for particular ethnic groups or pre-placed with special institutions. In the privatization of the Malaysian International Shipping Corporation, a substantial portion of the shares were placed with Bumiputra (native) institutions and not available through public offering.

Special share allotment plans have also been utilized extensively in privatizations to encourage participation from employees and small investors. In the privatization of British Gas, for example, 40 percent of the offering was initially allotted to individual investors, 40 percent to British institutions, and 20 percent to overseas investors. Under this allotment scheme, when applications from individual investors oversubscribe their 40 percent allotment by over a hundred percent, shares from the allocations to institutions and foreign investors will be transferred to them, allowing them to obtain up to 64 percent of the total.

In order to encourage small investors to retain their shareholdings, governments sometimes also offer incentives such as loyalty bonuses to investors on the condition that they hold on to their initial shareholding for a minimum period of time. This approach has been utilized in the divestiture of Saint-Gobain in France as well as the British Gas. In Chile, loan advantages would be withdrawn if the initial buyer sells the shares to a third investor.

In most cases, the publicity and sales promotion techniques applied have largely influenced the attainment of share allotment targets. In addition, governments often intentionally set the offering price low enough to ensure a strong response on the first major public offering.[28]

Voucher Systems

In order to secure the transfer of ownership to the public, while sidestepping the problem of private capital scarcity, many Eastern European countries have distributed shares of former SOEs freely among their citizens. One model involves the establishment of **closed-end mutual funds**, or investment trusts (U.K.), to which shares of the former SOEs would be transferred. The shares of these mutual funds would in turn be freely distributed to the public according to a set formula.

The **voucher system** is a more popular mechanism for the free distribution of shares, especially in the former Soviet republics, Poland and Czechoslovakia.[29] Under this system, individuals receive vouchers which have a fixed face value in the domestic currency. Shares from privatized enterprises are tendered at a fixed price after a quick valuation. Households would have the choice of using their vouchers to purchase company shares directly or buying shares in mutual funds, which would use the vouchers to purchase the tendered shares. The initial distribution of vouchers can be made on an equal basis for the entire population or according to other criteria. The voucher approach has won widespread support in Poland and is viewed as politically superior to the direct distribution of mutual fund certificates, since it offers citizens a choice as to how they want to invest their capital.

The major drawbacks of the voucher system are the time-consuming nature of its implementation, the potentially prohibitive administrative costs involved, and its tendency to diffuse ownership so widely that effective control on management can be limited. If a majority of the ordinary citizens swap their vouchers for shares, share ownership becomes dispersed in small lots, the resulting administrative costs of which might leave little resources for profit distribution. In addition, special measure should be taken to ensure that vouchers do not become a substitute for cash, lest it should lead to an unintended expansion in money supply that is not synchronized with the public share offering.

Special Incentives

Governments have also employed **special incentive programs** to encourage the purchase of shares among small local investors. Some of the more widely used ones include pricing at a discount, the remittance of vouchers against the price of utility bills (e.g. gas vouchers to purchasers of shares of British Gas), low minimum share investment, and payments in

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[28] See p. 123-125 in Vuylsteke, op. cit..

[29] See "Implementation Booklet on Voucher Privatization," Prague, 1991.

installments. The extensive privatization of Chilean enterprises especially in the 1980s, offers a useful case study of some of the innovative techniques used to encourage "popular capitalism."[30] (See Box 6.1 below).

Extensive Publicity and Promotion

Publicity, promotion, and distribution mechanisms have proven to be key elements in achieving widespread share ownership, especially in countries with underdeveloped capital markets and where there is little knowledge and understanding of the rights and responsibilities of corporate shareholding among the general public. The privatization of the National Commercial Bank (NCB) and the Caribbean Cement Company (CCC) of Jamaica are good illustrations of how promotion and marketing campaigns can effectively achieve widespread participation from small local investors.[31] (See Box 6.2).

B. Lessons Learned on the Techniques for Encouraging Local Ownership

1. Employee discounts and stock ownership plans create profit sharing opportunities to labor and have proven to be effective in spreading ownership across wider classes of investors and, in some cases, even win over labor to the privatization process.

2. Individual shareholding restrictions which apply in a case-by-case or on an industry basis are more flexible and less cumbersome than enacting special legislation which restricts shareholding across sectors and industries.

3. The voucher system, while popular in Eastern European countries due to the choice of investment that it offers to the beneficiaries, is time-consuming and involves high administrative costs.

4. Special incentives such as pricing shares at a discount, low interest loans, and payments in installments have also been successfully used in ensuring the participation of small local investors.

5. Publicity, promotion, and distribution mechanisms are key to achieving widespread share ownership, especially in countries where the public has little knowledge and understanding of the concept of public shareholding.

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[30] See Techniques of Privatization of State-Owned Enterprises, Vol.II, Helen Nankani, World Bank Technical Paper No.89, 1988.

[31] See "Privatization in Jamaica: Two Case Studies," Roger Leeds, Center for Business & Government, Harvard University, December 1987.

Box 6.1

"Popular Capitalism" in Chile

The Government of Chile has designed and extensively applied a comprehensive incentive package to achieve "popular capitalism" in the process of diversifying SOEs since the mid-1980s. This mechanism was used in the divestiture of Banco de Chile, Banco de Santiago, a major electric utility company, and two major pension funds. Under this program, a comprehensive incentive package was offered to small investors for share purchases, including:

- ➨ Low interest loans (at zero real interest rate) with a 5 percent down payment and a 15-year maturity;
- ➨ 30 percent discount for timely debt repayments; and
- ➨ The use of 20 percent of the total investment as a tax credit against future income taxes.

To avoid concentration of shares, incentives available to each small investor were reduced as the volume of shares purchased increased, and purchases above the established limit were allowed only if they were paid in full at the time of purchase. As a result of a widespread distribution of shares, the previous shareholder equity was decreased to less than 12 percent of the new equity capital.

Source: Chapter 2 in Nankani, op. cit..

Box 6.2

Public Relations and Marketing: Two Case Studies in Jamaica

Before the floatation of NCB shares, a massive public education campaign was launched to familiarize the public with the concept of public shareholding. The media used included the radio, television, press conferences, audiovisual productions, and targeted briefings to selected groups of business associations and private sector organizations. In addition to distributing 170,000 copies of a comprehensive prospectus, it was reprinted in its entirety in the national newspaper one week prior to the offering.

To ensure that the collection and distribution outlets are easily accessible, a network of 400 outlets was set up at the branches of local banks and post offices, for a population of only two million people. With the aggressive public relations campaign and the positive reputation of the NCB in profitability and professional competence, it was not a coincidence that the public offering was met was public enthusiasm and oversubscribed by 170 percent.

Encouraged by the enormous success of the NCB offering, the privatization team for the Caribbean Cement Company (CCC) decided to use NCB's marketing campaign as the model. As with the NCB campaign, the objective was to educate the public about the stock ownership and to encourage widespread participation in the offering.

However, CCC was not as well known as NCB, and it did not have an impressive financial record. Thus, a major effort was undertaken to increase the public awareness and name recognition of CCC, including hiring a private advertising agency specifically for this purpose. The media marketing campaign intensified as the offering date approached, and efforts were carefully orchestrated to create the impression that the offering was in high demand and likely to be oversubscribed.

While a hundred percent of the company equity was publicly tendered, only 72 percent was sold within the first seven days, defying the public expectation of over-subscription and quick profit on the shares purchased. Overall, the offering should be considered a success by any objective standard, as it attracted over 23,000 investors and raised J$157 million ($28.7 million), the largest amount ever raised in a public offering in Jamaica.

Source: Leeds, op. cit.

6. Overly aggressive promotion campaigns could generate unrealistic public expectations and affect the public perception of success or failure of a public offering.

VII. OVERCOMING POLITICAL AND SOCIAL OBSTACLES TO PRIVATIZATION

ISSUE: Social and political opposition to privatization may arise from political parties, government bureaucrats, military leaders and organized labor. What are the principal strategies for overcoming political and social resistance, and what lessons have been learned from past attempts to eliminate or minimize these impediments?

A. Sources of Opposition to Privatization

Social and political opposition to privatization stems from the array of vested interests that state-owned enterprises engender. While SOEs can represent economic spoils to be doled out by political leaders in the form of jobs, status and funds, they can also be viewed as an issue of national security by the military. Government bureaucrats and employees may treat the SOEs as a source of tenured employment which often pays better than other opportunities outside the public sector.

Since privatization means wrenching SOEs from the hands of government officials and the loss of job security for their employees, governments are faced with a formidable and often risky task in attempting to break these interlocked coalitions. In short, governments often find it difficult to win popular support while implementing painful reforms. Opposition rises most strongly from: **(i) political leaders; (ii) intellectuals; (iii) government bureaucrats; (iv) the military; and (v) organized labor.**

Political opposition

Political leaders determined to oust the ruling party can conveniently use privatization as a political issue to attack their opponents. They may accuse the ruling party of doling out the choicest state assets to political cronies at less-than-fair prices, or pander to nationalism by claiming that enterprises are being sold to foreign investors who have little interest in the welfare of average citizens. Opposition parties, especially those which are more closely tied with labor groups, may also try to gain political grounds by claiming to oppose privatization in the interest of labor.

Intellectual Opposition

Ideological opposition may come from the intellectual community (e.g. academic scholars, university professors, writers), which may oppose privatization on the grounds that private ownership would promote income inequality, especially if the new ownership of the former SOEs is biased towards the rich and the privileged.

Bureaucratic Opposition

Government bureaucrats opposed to privatization may claim that certain enterprises can better serve public interest when they are publicly owned, but more likely than not, they fear losing their tenured jobs and other financial privileges that come with overseeing SOEs. Overcoming bureaucratic opposition is particularly difficult because it is often covert and manifests itself in the form of endless delays and procrastination rather than open public protests.

Military Opposition

In some developing countries, the military has been directly involved in economic management or the control of SOEs, especially those in strategically important sectors. When military regimes rose to power in many Asian, African, Middle Eastern or Latin American countries, they often created their own industrial and business enterprises which provided jobs for ex-soldiers or supplied an independent source of funding for the militia's own use. In countries where the military is heavily involved in the civilian economy, the military establishment can represent a formidable opposition and pose significant threats to the privatization process.[32]

Labor Opposition

Organized labor is naturally fearful of the possible loss of seniority, unemployment or wage reductions which often accompany privatization. Such fear is well grounded considering the level of excess employment prevalent in many SOEs, and the considerable savings that can accrue from eliminating redundant workers.

B. Overcoming Social and Political Opposition

Countering political and social opposition involves a variety of techniques including: (i) **enlisting the support of government officials; (ii) mounting effective public relations campaigns; (iii) encouraging widespread ownership; (iv) creating a transparent and open privatization program; (v) challenging bureaucratic opposition; (vi) pacifying military leaders; and (vii) including labor in the privatization process.**

Enlisting the Support of Top Government Officials

In some countries, respected political figures have successfully martialled public opinion in favor of privatization through policy statements that defined the scope of the country's privatization program and promoted it as a desirable national goal. While multilateral lending

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[32] See "The Political Factor in Privatization" by L. Gray Cowan, 1988 for USAID Center for Privatization.

agencies and foreign consultants can provide useful technical assistance to conduct privatization transactions, there is no substitute for the public support that can only be marshalled by political leaders to counter the opposition.

Kenya's 1991 privatization effort, for example, was accompanied by well-publicized announcements from the Vice President and the Minister of Finance that the government intended to rapidly divest all non-strategic parastatals. "Non-strategic" was emphasized to avoid the public impression that national security would be compromised.[33] Mexico's experience is another case in which privatization has enjoyed considerable success partly because President Salinas de Gortari has publicly made it an integral part of his overall economic reform blueprint. The solid endorsement by the country's highest elected official and the degree of commitment to the program signalled to the public were critical to overcoming opposition to the privatization process.

Aggressive Public Relations Campaigns

An effective public relations campaign is critical in that it allows the government to present a persuasive case for privatization to the public before the opposition has the chance to exploit public ignorance of the issue. The most effective campaigns are the ones which demonstrate clearly how the benefits of privatization outweigh the costs, and that the eventual losses from not privatizing exceed any short term economic dislocations.

In Box 7.1 below, the case study and the lessons learned from the public relations campaign in the privatization of the Caribbean Cement Company in Jamaica are described.[34]

Encouraging Widespread Private Ownership

Experiences in many countries have demonstrated that widespread ownership of SOEs has successfully garnered public support for privatizations. Not only do public offerings distribute the ownership of former SOEs widely among citizens, this technique is also effective in building a new political constituency with a vested interest both in preventing re-nationalization of the enterprise and in supporting future privatizations.

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[33] See "Parastatals in Kenya: Assessment of their Impact and an Action Plan for Reform" by SRI International, 1992.

[34] See Privatization in Jamaica: Two Case Studies, Roger Leeds, Center for Business & Government, Harvard University, December 1987.

Box 7.1

The Public Relations Campaign for The Privatization of the Caribbean Cement Company

When the Government of Jamaica formally launched the privatization campaign of the Caribbean Cement Company (CCC) in March 1987, it encountered strong opposition from former Prime Minister Michael Manley's People's National Party (PNP). During the week before the shares were to be offered for sale, a national newspaper ran a feature article detailing the opposing position of the PNP to the privatization. A PNP spokesman was quoted saying that the divestment "does a great injustice to the Jamaican consumers and tax payers by transferring at discount prices the benefits they should derive to a few investors and speculators who will number no more than 10,000 to 20,000 people."

Although the public relations campaign for CCC did not directly address PNP's criticism, one of the dominant themes emphasized that the Jamaican people would be the major beneficiaries of the process. The public comments of Prime Minister Seaga also stressed that CCC's privatization was designed to "favor the small investor" and that a major objective of his privatization program was to "ensure that ownership would be democratized." In addition, a number of endorsements from labor union leaders were prominently mentioned in the press.

The marketing strategy included the use of radio, television, press conferences, feature stories in national newspaper, audiovisual production and targeted briefings to various interest groups and business associations. As the offering date approached, the media campaign intensified. To ensure wide public access to the prospectus and information on the offering, copies of the prospectus were distributed to bank branches, supermarkets and post offices around the country. Efforts were carefully orchestrated to create the impression that there was a high degree of interest in the upcoming sale.

Despite its undersubscription, the offering succeeded in attracting 23,000 investors and raising J$157 million ($28.7 million), the largest amount ever raised in a public offering in Jamaica, exceeding that of the previous offering of National Commercial Bank shares.

Source: Roger Leeds, ibid.

In Russia, where 50 percent of small state enterprises have been privatized, the newly acquired shareholdings have created an emerging propertied class that will serve as a major base for further economic reforms in the country. According to Deputy Prime Minister Anatoly Chubais, the Cabinet member in charge of privatization, the main support for his privatization program was from "the people who have become stockholders in their own enterprises, swapped their privatization vouchers for stock in enterprises and won bids to buy shops or restaurants." As the new propertied class expands, it will be increasingly difficult to reverse the trend of privatization or re-nationalize enterprises.

Box 7.2 below describes how a constituency for privatization can be built through widespread share ownership.

<u>Creating a Transparent and Open Privatization Process</u>

A privatization program governed by transparent laws and regulations is often perceived as more fair and attractive than one riddled with loopholes and inconsistencies. Clear privatization laws not only attract foreign investors, but also allay domestic fears that the political elite and wealthy foreign investors will exploit the privatization process for their own profit.

In Senegal, for example, a Privatization Law enacted in 1987 stated that the primary objectives of the privatization program were to increase accountability of public enterprises and to encourage widespread ownership of enterprises.[35] Poland's 1991 Privatization Law required that at least 20 percent of the shares of a privatized company be reserved for workers. This type of legislation, although it might reduce the degree of flexibility in implementing privatization transactions, is nonetheless an important signal to the public that fair and transparent rules are clearly laid out and observed.

[35] See "Mission on Privatization: Senegal" by Jean de la Giroday, for USAID Center for Privatization, 1987.

Box 7.2

The Privatization of British Telecom

British Telecom (BT) was the first major utility company to be privatized under the major privatization program of Prime Minister Margaret Thatcher. An important innovation of the BT sale was the extent to which the share issue was targeted at small investors by advertising, generous pricing, share allocation rules, and loyalty bonuses. Since each applicant was limited to a maximum of 800 shares, large investors, especially institutional investors, had to buy their shares on the stock market, resulting in a 33 percent capital gain on the first day the BT shares were publicly traded. Needless to say, the two million shareholders immediately benefited from their initial stock purchases. The BT privatization was so popular with the general public that the Labor Party, which had threatened to take back the shares when privatization was first announced (when and if Labor returns to power), has since promised that the public could retain their shares should Labor return to power.

Source: Privatization and Development edited by Steve H. Hanke, Institute for Contemporary Studies, 1987, p.184-5.

Challenging Bureaucratic Opposition

While persistent pressure on ministries and agencies which delay the privatization process is often necessary, it is sometimes insufficient for overcoming the complexities of a large-scale privatization program. In cases where privatization spans the jurisdiction of several ministries or agencies, some governments have found it more effective to concentrate privatization in the hands of a secretariat that reports directly to the head of government and is empowered to override the objection of departments below it. For this reason, in Eastern Europe and the former Soviet republics where the scope of privatization requires enormous coordination among various ministries, the governments have created special privatization bureaus to manage the process.[36]

Military Opposition

Military opposition is always a sensitive area. In cases where the military exercises considerable political influence, it may be necessary to retain some officers on the boards of privatized firms simply as a cost of privatization. Apprehensions about the privatization of strategic industries can sometimes be eased with legal provisions that permit governments to requisition production through "golden shares" in the event of national emergency.[37]

Including Organized Labor in the Privatization Process

Integrating organized labor's concerns is crucial for equitably addressing the concerns of workers who are often the ones most directly affected by privatization. The best strategies for overcoming opposition from labor involve provisions for worker ownership and for social safety nets. The principal social safety net schemes include: direct income compensation; employee ownership plans; credit schemes; employment services; job training and employment-generating programs. These strategies are discussed in detail in Chapter IX of this report.

C. Lessons Learned about Overcoming Political and Social Obstacles to Privatization

1. The demonstrated commitment and support of top government officials is key to marshalling public support for the privatization program.

2. The most effective public relations campaigns are those which persuasively demonstrate that the benefits of privatization outweigh the costs, and that the eventual costs to the economy from not privatizing exceed short-term pain caused by dislocations.

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[36] See Cowan, op. cit..

[37] See Cowan, op. cit., 1988.

3. Widespread share ownership creates a constituency with an interest in preventing the re-nationalization of the enterprises, as well as supporting future privatizations.

4. A transparent and open privatization process helps build public support for privatization, as long as the goals and process are perceived to be fair and in the interest of the ordinary citizens.

5. In Eastern Europe and the former Soviet republics, superministries which report directly to the Head of the State have been created to provide overall coordination of privatization and to sidestep the bureaucratic obstruction from the various ministries involved.

6. To alleviate military opposition to privatization, in some cases it might be necessary to retain some officers on the boards of privatized firms.

7. Labor opposition can be successfully diffused if workers are offered reasonable compensation in the form of shares or severance pay and/or training and alternative employment opportunities.

VIII. ENVIRONMENTAL ISSUES AFFECTING PRIVATIZATION

ISSUES: Potential liability for environmental damage caused by former SOEs has been one of the main obstacles to rapid privatization in several countries in Eastern Europe and Central Asia. The main issues which have emerged in those countries include: identifying the extent of liability for environmental damage caused by the former SOE, determining which party bears responsibility; deciding which party is responsible for site clean up; and establishing clear environmental standards for current and future operations.

A. Impact of Privatization on the Environment

Before addressing the issue of environmental liabilities of former SOEs, it is important to first explore the question of whether private companies are less polluting than public companies. Although there is no hard evidence comparing how much state-owned companies and privately owned enterprises contribute to pollution, a circumstantial case can be made that privatization will be better overall for the environment (See Box 8.1 below).

Public enterprises account for a substantial portion of the production in the most pollution-intensive industries. SOEs account for all of Tanzania's fertilizer, cement, iron and steel production, and about 85 percent of its pulp and paper output. In India, Mexico and Venezuela, all the oil refining and distribution as well as a large share of metals production are in state hands. These firms are often sheltered from competition and tend to use older, more-polluting technologies.

The ineffectiveness of inducing public enterprises to reduce their level of pollution is illustrated by the case of Poland (see Box 8.2 below).

B. Methods for Addressing Environmental Liabilities Affecting Privatization Transactions

A major concern of property and casualty insurers in Europe and North America is the expanding interpretation of environmental liability. Environmental liability is more difficult than other types of liability because the payouts are potentially enormous, and the risks are difficult to assess.

Box 8.1

Does Privatization Increase or Decrease Pollution?

Arguments that private companies are less polluting:

- Private companies are more likely to face litigation over environmental liabilities; therefore they are more willing to comply with environmental control standards and invest in cleaner technologies.
- SOEs tend to use older, more pollution-intensive technologies than do private firms. Foreign investors from developed countries often install cleaner technology which conforms to the stricter environmental pollution standards of their home countries.
- SOEs may more easily avoid compliance with pollution control because of their collegial relationship with government oversight agencies and because of the "soft budget constraint" which reduces effectiveness of fines and other financial incentives.
- SOEs have benefited from protection from competition and have tended to be in more materials-intensive and energy-intensive industries.
- Government planners in socialist countries often strived to maintain production targets for their SOEs at the expense of other objectives such as health and the environment.

Arguments that public companies are less polluting:

- Since private enterprises face more competition and are more cost-sensitive, they may have less incentive to invest in pollution-reducing technologies and production methods.
- Private companies are better able to hide information from the government than SOEs, rendering regulatory control on them more difficult.
- Privatized companies are more likely to be owned by foreign investors, some of whom may have chosen the offshore investment site in part because of its looser environmental standards compared to those in their home country.

Sources: Kikeri, Nellis and Shirley, op. cit., p. 57-58, and SRI International

Box 8.2

Controlling Emissions from Public Enterprises in Poland

In Katowice, Poland, state-owned enterprises were implicated in severe and persistent pollution that caused extreme levels of exposure to particulates. Steel mills, nonferrous metal smelters, chemical plants and power stations were the principal polluters.

Throughout the 1980s the provincial government in Katowice attempted to improve the city's air quality by levying fees for emissions that exceeded permissible levels. Although the pollution fines were double those set by the national government for the rest of Poland, they were revised infrequently during the 1980s and fell sharply in real terms amidst high inflation.

Because state-owned industrial plants argued that they lack the financial resources to invest in better environmental control equipment, emission permits were typically set too high to achieve reasonable ambient air quality, and enterprises were often exempted from paying fees and fines. Provincial governments did have the authority to close down persistent emissions violators, but this power was exercised only once – for an aluminum plant in Krakow that was to be closed down already for other purposes.

The situation in Katowice has changed dramatically since 1990. Air quality has improved significantly and enterprises are investing in environmental control equipment. There are three reasons for the change: (i) some of the worst polluters have closed down; (ii) several of the firms have been privatized and the new owners have installed pollution control equipment that meets the strictest Western European standards; and (iii) the levels of fines has increased over ten times in real terms and payment is enforced under a threat of closure.

Source: The World Development Report 1992, the World Bank, p. 131.

Potential liability for environmental damage caused by the former SOEs was one of the major obstacles which initially hindered privatization programs in Eastern European countries including Poland, Hungary, Germany and the Czech Republic. These countries began to receive requests from foreign investors to indemnify them against possible environmental claims that might arise from existing contamination at the site they were considering purchasing.

For many Eastern European countries, this was their first introduction to an issue that has become a commonplace part of property transaction in North America and Western Europe. Several Eastern European countries acknowledged that they had not anticipated the strength of investor concern about environmental liabilities.[38] After this abrupt introduction, governments have devised new laws and strategies for dealing with environmental liabilities. They also wanted to take advantage of the changes brought about by new ownership as an opportunity to introduce stricter environmental standards throughout their industry.

Three major types of environmental issues which must be addressed to satisfy the concerns of most investors and governments are:

- Current discharges to air, water, and soil that are the result of the SOE's industrial or commercial activity;

- Past pollution on site that is the result of inadequate pollution control or handling of wastes; and

- Past pollution that has either migrated off site or might migrate off site in the future.

The above issues raise several practical questions for investors. Buyers want to know the extent of their liability for environmental damage or violations due to the former SOE. If liable, they often want to limit the extent of their liability through indemnification, or alternatively they may offer a lower purchase price to reflect the environmental liability. Investors also frequently want to know if they will be given a certain time limit to comply with the environmental standards to which the SOE facilities do not currently conform. Another issue which must be addressed is to determine which party -- the government or the investor -- will bear the clean up costs incurred in bringing a site up to standards.

These questions may be answered in the country's environmental or privatization laws, or in individual divesture contract agreements. The approaches that Poland and Germany took to tackle these environmental liability issues are illustrated in Boxes 8.3 and 8.4 below.

[38] See Keynote Address of, Jerzy Strzelecki, Polish Ministry Of Privatization, at Conference on "Foreign Direct Investment and Environmental Liability in Eastern Europe," May 1992.

Box 8.3

Privatization and the Management of Environmental Liabilities in Poland

Potential liabilities for environmental damage caused by former SOEs was at first a major stumbling block for the sale of large companies to foreign investors in Poland. Starting in 1991, the government began to devise strategies to cope with the environmental liabilities of former SOEs. New policies have been formulated in large part on the basis of the experience gained in the context of specific transactions.

The Polish Environmental Protection Agency requires that an environmental audit be conducted for all large SOEs to be privatized. The environmental audits review the company's production history, existing environmental permits and compliance records, possible contamination release incidents and its present environmental practices. Because of cost and time constraints, however, the initial audits generally do not sample soil, air, or water.

The environmental audits allow investors and the government to establish a baseline determination of the existing level of pollution. Depending on the kind of information the government's audit produced, investors sometimes conduct their own audits to review the level and degree of compliance with existing permits and other environmental requirements.

Poland had little difficulty in determining its policy of allocating responsibility for *current environmental discharges.* They determined that responsibility for bringing current discharge levels up to standards is the responsibility of the investor. The Ministry of Privatization has rejected contractual agreements that would require the government to bring enterprises up to standard. One of the explicit objectives of the privatization program was to bring new investment and more modern technology to the country.

While it is the investors' responsibility to bring enterprises up to environmental standards, the anticipated cost of such an endeavor is taken into account in the offering and accepted purchase prices.

Regarding *on-site contamination* as a result of past SOE failure to control pollution, the first step is to assess the extent of the problem and what remediation is necessary. Then a cost estimate for clean up must be developed. In lieu of a comprehensive set of clean-up standards, authorities to date have established that standards would be set no harsher than Western European standards (the Dutch and German standards have been used for reference).

Box 8.3
Continued...

The cost of clean up is borne by the government through the use of *escrow accounts*. These accounts are funded by a clearly identified portion of the revenue from the SOE sale. The account can only be drawn down to pay for site remediation. The government sets a specific time period for clean up, and any escrow funds remaining after the time period expires return to the government. Site clean up is usually implemented by the investor or by outside private firms contracted through competitive tender.

In most cases, the escrow account arrangement has been sufficient to close deals regarding the on site contamination, but in a few cases investors requested further guarantees that they would not have to bear any future costs connected with existing site contamination.

Regarding potential *liabilities for off-site impact of site contamination*, the Polish policy has been to offer time-limited indemnities against third party claims. The Polish Privatization Ministry's position has been that it will assume responsibility if an injury was caused by activities that can be clearly identified as having been caused before the end of the clean-up period. If claims develop after the end of the remediation period, the investor has the burden of showing that the injury falls into the category of injuries described above, for which the state has agreed to be responsible.

Source: "Capital Privatization and the Management of Environmental Liability Issues in Poland," publication forthcoming in Business Lawyer, American Bar Association.

Box 8.4

Germany's Legislative Changes to Address the Issue of Environmental Liabilities of SOEs

In order to overcome investors's fears about potential liability suits, Germany made changes in its legislation to allow regional governments to release investors from environmental liabilities arising from SOEs' pre-divestiture activities. As a result the country's treasury had to bear most of the potential cost of environmental clean up and related liabilities.

In 1991 the government of Germany realized that strict application of West German environmental laws would result in a shut-down of most of East Germany's industries. The authorities responded by modifying the Environmental Framework Act in 1991 to grant purchasers of industrial plants indemnification from environmental damages caused by the operations of the plants before July 1, 1990.

In addition, the Privatization Amendments of 1991 provided for the possibility of indemnification to private investors from third party civil suits as well as from public claims arising from environmental liabilities related to SOEs' pre-divestiture activities.

The German Privitization Ministry agreed to absorb the bulk of the cost of environmental damage existing at the time of purchase. While the percentage is subject to negotiation, the Ministry in the past has assumed up to 90 percent of the related costs.

The prospect of future liabilities for environmental damage also convinced German privatization policymakers of the need to convert the legal form of SOEs before privatization. Most SOEs are wound up and dissolved before ownership change. Consequently, the new purchaser is only buying the assets from the old company and is not assuming the SOE's past liabilities.

Source: Guislain, op. cit..

C. Lessons Learned About Environmental Issues Affecting Privatization

1. Although there is no hard evidence comparing how much state-owned companies and privately owned enterprises contribute to pollution, a circumstantial case can be made that privatization will be better overall for the environment.

2. Potential liability for environmental damage caused by the former SOEs was initially one of the major obstacles hindering privatization programs in Eastern European countries. This was overcome by identifying the extent of the evnironmental liabilities before privatization and determining who bears responsibility for the liabilities.

3. Buyers want to know the extent of their liability for environmental damage or violations due to the former SOE. If liable, they often want to limit the extent of their liability through indemnification.

4. Environmental audits of sites to be privatized can provide a baseline of information about current pollution activities and on-site contamination.

5. It is usually the responsibility of the new buyer to control current discharges.

6. The cost of site clean up for pre-divestiture pollution is often borne by the government, but clean-up activities themselves are often carried out by the buyer or specialized private firms.

7. Many countries, including Poland, have set up escrow accounts to pay for site remediation. Escrow accounts have provided limited indemnification, which has helped reduce investor uncertainty.

8. Providing a clear set of policies and rules regarding environmental liabilities helps ease investors' concerns and thereby facilitates privatization, while helping to safeguard the country against further environmental degradation in the future.

IX. LABOR RETRENCHMENT AND SOCIAL SAFETY NETS

ISSUE: Workers and labor unions are extremely sensitive to privatization and their opposition can often delay the privatization process. What are the best strategies for reducing opposition from these groups and minimizing the adverse social effects of labor adjustment?

A. Principal Labor Adjustment Strategies

In the short run, privatization tends to be associated with worker retrenchments. In the longer term, the objective is that privatization will lead to increased employment through a more dynamic and expanding private sector. However, most often the longer-term employment benefits from privatization tend to be less visible than the short term retrenchments.

Typically, in cases where firms targeted for privatization are profitable operations with commercial management and relatively efficient work forces (often when the government owns only a minority share), the changes brought about by the government selling its shares in these companies are likely to have a relatively modest impact on the structure of the existing work force. Retrenchments in those cases are not likely to be significant.

However, in cases of loss-making companies which require substantial restructuring or liquidation, retrenchment of a portion or all of the existing work force can occur, with the potential of causing significant social disruptions.

Several labor adjustments and social safety net strategies have been introduced in different countries in an effort to minimize the social costs of privatization. The chief strategies utilized include: **(i) direct income compensation; (ii) employee ownership plans; (iii) employment and information services; (iv) job training; (v) special credit programs; and (vi) employment-generating programs.** Relevant case studies illustrate how such strategies have been implemented in several developing countries.

<u>Direct Income Compensation and Employment Subsidies</u>

Income compensation and employment subsidies are designed to either compensate workers dislocated through privatization or reimburse the new private owners who sustain excess employment until workers find new job opportunities. **Severance pay and bonuses for early retirement** are examples of direct income compensation which use financial incentives to encourage voluntary reductions in the work force. While these schemes are attractive to the employees, they can also be costly for the government (See Box 9.1 below).

Box 9.1

Severance Payments in Ghana

Ghana's efforts to privatize many of its SOEs in the late 1980s was jeopardized by its inability to meet the generous severance payments it had agreed to SOE workers during collective bargaining negotiations. Between 1985 and 1991 end-of-service benefits grew to between $1,423 and $2,846 per worker, representing between four to seven times the per capita GNP.

The government had originally intended to fund these payments through proceeds from the sale of SOEs, but revenue for privatization fell short of expectations, the government was forced to meet these payment obligations through its annual budget. Due to other competing budgetary obligations, Ghana was unable to meet payment obligations and to date only 20 percent of the benefits have been disbursed.

The absence of a clear and realistic plan for settling these liabilities has delayed the privatization of large SOEs and has diminished the interest of private investors. Labor groups have been reluctant to renegotiate the terms of the earlier agreements for fear of losing generous benefits, while private investors have been wary of inheriting a company that binds them to honoring the government's severance payment obligations.

Ghana, and other countries in similar positions, have several options for breaking this kind of gridlock. For example, they can attempt to renegotiate severance benefits with the intention of replacing lump-sum disbursements with payments spread over several years. They can also seek outside sources of funding. While most donor agencies including the World Bank do not lend for end-of-service payments, they do lend for structural adjustment packages that might allow for a portion of funds from the annual budget to be allocated to severance payments.

To similar problems in the future, Ghana has recently created a national pension scheme to replace the practice of negotiating separate enterprise pension plans. It is also considering the creation of a national contributory unemployment scheme. In addition, it has frozen the retirement gratuity portion to year-end 1990 levels, and has called on SOE boards to renegotiate the benefits with their employees.

Source: Kikeri, Nellis and Shirley, op. cit., p.61.

Severance schemes can be complicated by the potentially conflicting strategies of devising pay schedules that encourage enough workers to leave voluntarily on the one hand, while still providing adequate incentives to retain the most productive workers. It can be a delicate balance attempting to achieve these different objectives simultaneously.

The Bolivian Central Bank is an example of a public institution which succeeded in both reducing the number of workers and retaining its most productive employees through its retrenchment exercise during the mid 1980s. After a review of the Bank's operations, the Bolivian authorities concluded that the Bank could be more efficient with a smaller -- but more productive -- work force. They decided that the work force could be reduced from 1000 to 400. The authorities also determined that the future wage savings from a smaller staff could enable the Central Bank to finance generous severance payments for displaced workers and offer merit-based pay increases to those remaining on the job. The net result was a more efficient work force and overall reduction in personnel costs.[39]

Unemployment benefit schemes that pay dislocated workers a percentage of their previous earnings over a fixed period of time are considered equitable yet expensive -- similar to severance pay schemes. The advantage of unemployment benefits is that they provide workers with ongoing financial support while they search for new job. However, unless combined with other programs such as job training, unemployment benefits, alone, do little to prepare workers for alternative occupations once their payments expire.

Government absorption of employees was attempted in Tunisia when the Fluobar Company was restructured and the government agreed to pay the salaries of displaced workers until they found jobs elsewhere.[40] Despite its success in this particular case, this strategy represents a potentially costly option which entails continued dependence on the public sector for employment.

Committing new owners to maintaining employment for agreed intervals after privatization provides a transitional period of security during which time natural attrition may resolve the problem of over-employment. The **disadvantage** of postponing labor retrenchment in SOEs about to be privatized, however, is that the policy may make new buyers wary of a company for which the labor problems have not yet been resolved. The cost of labor adjustment is often passed back to the government which is being forced to accept a lower selling price for the enterprise.

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[39] See Industrial Restructuring Policy and Practice by Ira Lieberman, The World Bank, 1990, p.20.

[40] See Vuylsteke, op. cit., p.135.

Employee Ownership Plans

Some countries have managed labor or wage adjustments through **employee buy-outs** that allow employees to acquire controlling interests in companies. For example, the Polish privatization law requires that when a company is being privatized, at least 20 per cent of shares must be reserved for workers at a discounted prices.[41] Under employee buy-out schemes, employees may be more ready to accept wage reductions, in exchange for a discounted share in the company's ownership. Clearly this approach represents a better solution for employees whose enterprise would otherwise face liquidation.

The **disadvantage** of this strategy is that it increases the financial burden on workers who may already have little or no financial security; if the venture fails, employees lose their share investment as well as their jobs. See Box 9.2 below for a case study of a successful employee buy-out in Chile.

Employment and Information Services

Employment and information services attempt to reduce frictional unemployment by preparing dislocated workers for relocation to another company or sector. The main types of employment and information services are described below.

Job search services such as counseling, referrals, and information on the job market assist workers in locating new positions. Experience has shown that job counseling is a vital service to provide workers who are facing possible lay-offs. These services are most effective when they are made available on site at the SOE facing downsizing.

Advance notification of plant closures or layoffs allows employees time to begin searching for another position, and can also diffuse opposition to the sale of enterprises. For example, feasibility studies for a 1988 World Bank funded Industrial Restructuring Project in Senegal determined that of the 5,000 layoffs resulting from the project, 3,000 would have occurred anyway because of declining competitiveness.[42] Public dissemination of this information convinced workers faced with eminent unemployment to negotiate alternative plans that included severance pay, early retirement and job training.

Relocation services are critical in cases where plant closures are concentrated in one region. Mining projects or large industrial enterprises downsizing can have particularly strong regional impacts which require special consideration and compensating measures.

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[41] See "Accelerating Privatization in Eastern Europe: The Case of Poland" by Jeffrey Sachs in Proceedings of the World Bank Annual Conference on Development Economics 1991, The World Bank, 1992, p. 20.

[42] See Lieberman, op. cit., p.20.

Box 9.2

Employee Buy-out of ECOM in Chile

The privatization of Chile's largest computer firm was completed as an employee buy -out. In 1986, Chile's state holding company CORFO decided to privatize Empressa Nacional de Computation e Informatica (ECOM), which had been losing money steadily since 1983. The company's weak financial position discouraged most private investors, and the only group that showed interest in acquiring the firm was its employees. ECOM was sold to the employees under the following arrangements: (i) 10 percent of the purchase price was paid through an advance of retirement funds; and (ii) the balance of 90 percent was financed through a 10 year loan from CORFO, at a 5 percent interest rate.

After reorganizing the company, reducing salaries, and selling off disposable assets, the new owners realized a profit of $250,000 in 1986. While the case of ECOM illustrates how employee buy-outs can be successful, the privatization was significantly facilitated by the involvement of the state agency CORFO which accepted a reduced price for the firm and provided low-cost financing to facilitate the sale. It is not clear, however, the extent to which the project could be replicated elsewhere in the absence of such special financial terms.

Source: Nankani, op. cit., p.36-38.

Job Training

Job training strategies target structural unemployment and focus on investment in human capital as a means of providing new employment opportunities for displaced workers. Most of these schemes aim to increase labor productivity by teaching occupational skills or providing basic education.

The **drawbacks** of these schemes are that implementing government agencies are usually not very good at designing training programs which meet the fast-changing needs of the private market. Private companies are often reluctant to undertake extensive training or retraining programs because of the high costs or because of the concern that they may lose the workers to other companies after they have devoted substantial resources to training them.

To overcome these problems, some countries have implemented a program of **contract training**, which prepares workers for specialized positions within a specific private company that has agreed to participate the program. The most effective programs provide tax or other financial incentives to the firm -- only made available on the condition that the trained workers later are retained by the firm in the capacity in which they have been trained.

Focussing on self-employment as a possible solution to unemployment, **micro-enterprise development assistance and entrepreneurial training** helps entrepreneurs to develop and operate their own businesses successfully. This strategy works best as part of an integrated approach that provides both **credit and technical assistance**. Some governments have integrated this strategy with other schemes by allowing workers to use unemployment benefits or severance pay to capitalize their enterprises.

Special Credit Programs

Employed workers who are interested in starting their own business enterprises are often constrained by the **lack of investment funds**, even though their credit needs are generally very modest. Thus, improving access to credit for business start-ups could be considered as part of the package of assistance offered to workers facing lay-offs.

Experience with providing micro-enterprise credit has shown that these types of programs are the most effective when they are built into existing systems or mechanisms in allocating loan capital to enterprises. To improve access to credit to dislocated workers for business start-ups, the government can provide small subsidies or limited loan guarantees to small borrowers via credit institutions and/or programs.

However, such programs should be **demand-driven instead of credit-driven**. Credit should only be allocated to feasible projects and not made available as if it were an entitlement. Borrowers should be discouraged from treating loans as grants that do not have to be repaid. In the cases where only large subsidies can induce additional lending by existing institutions to micro-enterprises, lump-sum grants are generally a better alternative to loans.

Employment-Generating Programs

Public works programs represent another option to countries undertaking privatization programs that have a significant impact on the labor market. Introducing government-sponsored works programs can provide jobs in the short run, while contributing to the overall economic development of the country for the long term. Many countries undergoing structural adjustment and industrial restructuring have instituted labor-intensive public works programs in an effort to provide employment opportunities for displaced workers, while build infrastructure for sustainable growth in the future.

Bolivia introduced such a program in 1986 following a series of economic setbacks including the closure of the state-owned mining company COMINBOL which displaced 23,000 workers.[43] In response, the World Bank and several bilateral donors funded a $181 million Emergency Social Fund which sponsored over 7,000 projects affecting some 20,000 workers. Among the projects approved for ESF funding were: (i) economic infrastructure; (ii) social infrastructure including schools and health care facilities; and (iii) production support, mainly through credit to micro-enterprises and cooperatives. Overall, the program is considered to be highly successful as substantal economic infrastructure was developed and thousands of workers were able to find productive employment through the program.

Several other countries including Ghana, Guinea, Guinea-Bissau, Senegal, and Mexico have recently secured funding for similar public works programs.

B. Lessons Learned on Labor Retrenchment and Social Safety Nets

1. In the short run, privatization tends to be associated with worker retrenchments.

2. In the longer term, one of the primary objectives of privatization is increased employment through a more dynamic and expanding private sector. However, the longer-term employment benefits from privatization tend to be less visible than the short-term retrenchments.

3. Privatization that occurs as part of larger structural adjustment program or during a time of economic crisis often requires a more comprehensive social safety net to minimize the impact of unemployment.

4. Since unresolved labor issues prior to privatization typically deter private investment, implementing a labor retrenchment program prior to the sale of enterprises is generally a more effective strategy.

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[43] See Bolivia's Answer to Poverty, Economic Crisis and Adjustment: The Emergency Social Fund edited by Steen Jorgensen, The World Bank, 1992, p. 1-7.

5. Unless alternative opportunities exist for retrained workers, job training programs have proven to be insufficient solutions to long-term structural employment problems. In the absence of genuine employment opportunities, the program can raise unrealistic expectations of employment, and can cost the government/company substantial resources.

6. Employee buy-outs can elicit support for privatization, preserve jobs, and help improve productivity in the process.

7. Well-designed severance schemes like Bolivia's have succeeded in encouraging enough workers to leave voluntarily, while still providing adequate incentives to retain the most productive workers. However without adequate financing severance schemes are difficult to implement, and can even threaten the entire privatization -- as the Ghana case illustrates.

8. Experience in many developing countries with training, credit, public works, and redeployment schemes has generally been less successful than severance payments. Such lump sum payments are easier to administer, more cost effective, and more likely to have a direct impact.

9. Special credit programs to assist small business start-ups among dislocated workers tend to be more effective when they are demand-driven. Dislocated workers should be discouraged from treating credit assistance as a grant that does not have to be repaid.

10. One of the best methods to finance severance payments is through the proceeds of privatization sales. Donors are becoming less willing to finance severance payments, unless it is done indirectly through budgetary or balance of payments support.

X. INVESTMENT REGULATIONS AND PRIVATIZATION

ISSUE: What kind of investment regime is required for a successful privatization program, and to what degree do overall investment policies such as investment codes govern privatization transactions?

A. Main Issues Relating to Investment Regimes and Privatization

The nature and friendliness of a country's investment regime are major determinants of investment, both foreign and domestic. Some aspects of the overall investment regime generally affect all investments, whereas others have a larger incidence on divestitures. For privatization opportunities to attract private investment, laws and regulations should be in place which streamline company incorporation procedures, facilitate foreign investment, guarantee foreign exchange convertibility and repatriation, and expedite dispute settlement.

When assessing privatization prospects in a country, there is a need to review the basic investment regulations and restrictions to ensure that they are not an obstacle to the privatization process. The impact of these issues and restrictions on privatization transactions will be explored in this chapter.

<u>What Private Investors are Seeking in Privatized SOEs</u>

Investors in privatized SOEs, both local and foreign, are generally seeking the same types of incentives, guarantees, and rights as private investors do for other kinds of investment.

Many developing countries have adopted investment codes or other investment legislation with the intent of encouraging private investment, both domestic and foreign. The incentives, guarantees and rights granted in these laws usually are intended to offset other distortions or dis-incentives to investment; otherwise no special investment code would be necessary. Most developing countries still find it necessary to have a code or law which provides guarantees, incentives, and basic rights to investors.

Although there is not one formula which summarizes the policy environment needed to maximize private investment, some general principles should be adopted by countries which are serious about attracting private investment. Most of the "investor-friendly policies" described in Box 10.1 below have been adopted in varying degrees by developing countries which have recently liberalized their investment policy regimes.[44]

[44] See for example, "Facilitating Foreign Investment," by Guy Pfeffermann, in <u>Finance and Development</u>, March 1992.

Box 10.1

Checklist of Investor - Friendly Policies

- ✔ Permit unrestricted entry of foreign investment in general, limiting restrictions or screening to a short "negative list."
- ✔ Provide equal treatment between foreign and local investors.
- ✔ Guarantee repatriation of capital and remittances of profits.
- ✔ Establish clear "rules of the game" and make investment policy and regulations automatic and non-discretionary.
- ✔ Make company establishment procedures a simple registration process.
- ✔ Clearly define types of investment that will garner incentives and grant these automatically, minimizing negotiations.
- ✔ Avoid "deal making" with individual investors.
- ✔ Allow firms flexibility in their own hiring/firing decisions.

Sources: Pfeffermann, op. cit., and March 1992, and SRI International various foreign investment policy papers and reports.

The policies outlined in Box 10.1 are the types of investment policies and guarantees that most buyers of privatized parastatals are also seeking. Where investment policy regimes differ sharply from this investor-friendly framework, corrective measures are necessary in order to ensure a successful privatization program.

Investment Policies Governing Privatization

One of the first questions an investor will ask before deciding to invest in an SOE being privatized is what macro-level laws and regulations will protect and regulate his/her investment. In most developing countries the two principal macro-level laws governing investment in privatized firms are the country's privatization law and the country's investment code.

Many countries enact specific privatization legislation as enabling laws giving the government or the privatization agency broad powers to privatize. One of the main objectives of most privatization laws is to ensure that the process of privatization is carried out in a transparent way, and that the institutional and legal structure for privatization is known to the public and investors.

Generally, investment guarantees, rights, obligations and incentives affecting buyers are not specified in macro-level privatization laws. These elements are usually addressed at the macro level in investment legislation or through company laws, and through various legal agreements needed to conclude the divestiture process at the micro level.

A question which often arises among investors, particularly foreign investors, is whether privatization transactions are actually governed by a country's investment code. In many countries, privatization transactions are not eligible for special incentives under the investment codes[45] because code incentives generally apply to new investments only, not to buying into or rehabilitating ongoing ventures. However, a few investment codes such as Côte d'Ivoire's provide specific incentives for SOE rehabilitation. The Zambian Privatization Law also establishes conditions under which foreign buyers of SOEs are eligible for incentives provided under the Investment Act.

Even when privatization transactions are not eligible for special incentives under countries' investment codes, they may be eligible for common incentives provided by the same codes which are generally available to most companies. In addition, privatized companies may be eligible for the general guarantees provided by the investment code or other general business laws on such issues as foreign exchange convertibility and repatriation, dispute settlement mechanisms, freedom to hire and fire, etc.

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[45] See Vuylsteke op. cit, Volume I, World Bank, 1988, page 92.

Box 10.2 below provides a "checklist" of key investment regulations and guarantees that might affect investors in privatized companies in developing countries. Restrictions in these areas or ambiguities in the laws governing private investors' rights and obligations will slow down transactions or will totally deter private investment in SOEs offered for privatization.

Complementarity Between Investment Laws and Divestiture Legislation

A number of countries have **adjusted their investment laws** to accommodate changes required by the privatization program. Other countries have had such vague overall investment frameworks that they have imposed undue negotiating difficulties on each privatization transaction. Still other countries have conflicting provisions under investment and divestiture laws which confuse investors.

Examples of countries which have modified their investment laws and procedures in part to accommodate the needs of the privatization program include Hungary, Russia, Morocco, and Nigeria[46] (see Box 10.3 below).

Some countries have had such **vague laws** governing investment that they have **imposed undue negotiating difficulties** on individual privatization transactions. Instead of providing the basic ground rules for foreign investment in macro laws such as investment codes, these countries have been obliged to negotiate the ground rules on a case-by-case basis through establishment conventions and divestiture agreements. Togo (See Box 10.4) provides an example of a country which began its privatization program without a clear investment policy framework.

Some countries have **conflicting investment and divestiture laws**, which confuse investors. Poland is an example of such a case. Its Privatization Law of 1990 specified that only 10 percent of the shares in a state enterprise company can be sold to foreign investors unless explicit permission is granted by the Ministry of Privatization. The Law encouraged local ownership through the use of the voucher scheme, mutual funds, worker buy-outs, and ownership transfer plans. The restriction on foreign investment in the Privatization Law conflicts with the existing Foreign Investment Law which allows foreigners to own up to 100 percent in companies in Poland.

When privatization laws and investment laws contradict each other the results are usually confusion among investors, and greater transaction time and costs.

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[46] See "Nigeria's Privatization Programme and the Role of Foreign Investment" by Dr. Hamza Zayyad, Chairman, Nigerian Technical Committee on Privatization and Commercialization, 1989.

Box 10.2

"Checklist" of Foreign Investor Regulations and Guarantees Under Privatization

1. *Investors' Rights and Obligations*

A. Investors rights and obligations are specified in:
____ Investment Code
____ Privatization Law
____ Company Law
____ Individual Divestiture Agreement

B. Dispute Settlement Procedures Relevant to New Buyers of SOEs are specified in:
____ Investment Code
____ Privatization Law
____ Individual Divestiture Agreement

2. *Investment Approval*

A. Investment approval is given to new buyers by:
____ Privatization Agency
____ Investment Promotion Authority
____ Other Authority

B. Investment Licenses are required:
____ Always
____ Only when special incentives are sought

C. Investors in privatized firms are eligible for special investment incentives through:
____ Privatization Law
____ Investment Code
____ Individual Divestiture Agreements

3. *Foreign Ownership*

A. There are minimum ____ maximum ____ limits on foreign investment in privatized SOEs

B. SOE companies or sectors open to foreign investors are designated by:
positive list ____
negative list ____

Box 10.2
Continued...

4. ***Capital***

A. Full dividend and profit transfers are guaranteed:
Yes ____
No ____

B. Capital repatriation is guaranteed:
Yes ____
No ____

C. Capital repatriation is guaranteed at:
____ full market value
____ original value
____ other

5. ***Labor***

A. Firm has freedom to hire and fire
Yes ____
No ____

B. Expatriate permits are for ____ years.

C. Expatriate permits approval is:
____ automatic
____ set by formula
____ subject to negotiation

Sources: Foreign Investment Advisory Service, World Bank and SRI International.

Box 10.3

Nigeria's Investment Code Liberalization as a Complement to Privatization

Privatization in Nigeria, as well as other countries, has been facing the potentially limiting constraint of a narrow pool of qualified buyers. Constrained to begin with by thin capital markets in that country, the small pool of buyers was further limited by investment laws which restricted foreign investment.

Recognizing that the existing pool of private capital and managerial skills was limited, the authorities responsible for privatization in Nigeria felt that no specific class of participants should be excluded from the privatization process. They were aware that the restrictive foreign investment regime was limiting investor response to their privatization efforts, and that corrective measures were needed to redress these constraints.

In 1988, Nigeria revised its Investment Code to remove restrictions on foreign investment, ease limitations on payments for royalties and technical services, and relax restrictions on the employment of expatriates. While the new reform measures were intended to improve the overall investment environment, the changes were inspired, in part, by the needs of the privatization program.

Source: Zayyad, op. cit..

Box 10.4

Togo's Privatization Efforts in the Absence of an Overall Investment Framework

In the early years of Togo's privatization program, the privatization effort was not systematic and initial progress was slow. The desire to sustain momentum, possibly combined with structural loan conditionalities, meant that the government did not take the time to establish a investment policy and regulatory framework within which the privatization program could be implemented.

It was not until 1985 – three years after the program was launched and after 4 privatization transactions – that an overall investment code specifying basic ground rules and rights for foreign investors was promulgated.

This lack of an overall framework placed a much greater burden on individual privatization negotiations. Such basic guarantees as a stable and favorable policy regime, free transfers of capital and earnings, customs duty reductions, and financial guarantees were included as part of the establishment convention agreements for the first two privatizations and in a lease agreement for a partial privatization.

Most important, the lack of an overall policy framework probably helped lead to some "quick deals" that have since been criticized by the public and by international organizations as being economically and financially unfavorable to the country. Under an establishment convention, for example, the government provided assurances to the buyer of the textile company that it would not establish or encourage the establishment of other textile companies in Togo with similar product lines. In addition, the government provided guarantees to the lessee of the steel company that it could import raw materials duty free, and benefit from a 41 percent protective duty on imported finished products, representing a high-effective rate of protection.

Source: Chapter 7 in Nankani, op. cit..

B. Lessons Learned About Investment Regimes and Privatization

1. The nature and friendliness of a country's investment regimes are major determinants of investment, both foreign and domestic, for privatization. Laws and regulations should be in place which streamline company incorporation procedures, facilitate foreign investment, guarantee foreign exchange convertibility and repatriation, and expedite dispute settlement.

2. When assessing privatization prospects in a country, there is a need to review basic investment regulation policies and restrictions to ensure that they are not an obstacle to the privatization process.

3. Where investment policy regimes differ sharply from an "investor friendly" framework, corrective measures are necessary in order to ensure a successful privatization program.

4. Although privatization transactions are not usually eligible for special incentives under countries' investment codes, they may be eligible for common incentives provided by the same codes which are generally available to most companies. In addition, privatized companies may be eligible for the general guarantees provided by the investment code or other general business laws.

5. A number of countries have adjusted their investment laws to accommodate changes required by the privatization program. The changes made have generally been in the direction of easing restrictions on foreign ownership, guaranteeing repatriation of dividends and capital, and loosening limitations on expatriate employees.

6. Some countries have had such vague macro-level laws governing investment policy that they have imposed undue negotiating difficulties on each privatization transaction. Moreover, the lack of an overall policy framework can lead to situations where government and private investors enter into "special deals" that are criticized as being economically and financially unfavorable to the country.

7. Investment and divestiture laws should be set under a consistent overall policy framework to avoid confusing investors.

8. Privatization in many developing countries faces the potentially limiting constraint that there may be a narrow pool of qualified buyers. The pool of buyers will be further reduced if foreign buyers or certain classes of investors are excluded by law or by practice. In particular, foreign investors should be welcome in line with the country's investment code.

XI. INVESTOR SEARCHES

ISSUE: Attracting participation of foreign investors is often critical to the success of privatization. What are the principal approaches used to target foreign investors, and to undertake marketing and public relations campaigns?

A. Principal Investor Search Techniques

When specific management or technical expertise is sought for the SOE to be privatized, selling the SOE to private investors through tendering or direct negotiations are the most common methods of divestiture. In cases where foreign investors are perceived to have the desired management skills, technology or access to export markets to maximize the enterprise's profitability, these investors are often targeted as high-potential buyers of SOEs. The principal channels for identifying potential foreign investors include **(i) existing contacts; and (ii) worldwide company surveys.**

Existing contacts are often a good starting point for identifying potential investors for privatization transactions. SOE managers or government officials may be aware of investors likely to be interested in the sale of the enterprise such as suppliers or purchasers looking for vertical integration opportunities, or competitors wishing to expand. In addition, contacts made through industry or trade associations may also provide important leads to potential investor groups.

A **worldwide company survey** in the same or similar lines of business is another method for identify potential foreign investors for SOEs. This survey is then limited to "major players" with the required investment capacity, and who are likely to be interested in offshore investment opportunities. This group of companies will form the target investor group. The interest of this group can then be elicited by contacting company officials directly.

For the privatization of an automotive glass manufacturer in Poland, an investor search initially identified over 200 companies as potential buyers. About 25 companies, or 15 percent of the companies contacted showed interest in the sale. It is expected that 10 companies will actually submit bids for the company. Thus, it is clear that in conducting an investor search it is prudent to cast a wide net among the target group in order maximize the responses from potential investors.

B. Principal Marketing and Public Relations Techniques

The process of attracting investors interested in purchasing divested SOEs follows the same basic framework as traditional investment promotion programs. The only difference is that for privatization marketing, individual projects are often more heavily emphasized than for the more general marketing of a country as a site for investment.

The SOE investment promotion team may be part of a country's general investment promotion structure, or part of a separate organization specifically devoted to promoting a country's privatization program. However, it is often cost-effective for the privatization program to utilize the established investment promotion, investor assistance, and information dissemination networks, both domestically and overseas.

The principal techniques for promoting foreign investment in SOEs include: (i) **direct mail and telemarketing; (ii) trade shows participation; (iii) investment missions; (iv) investment conferences; and (v) targeted advertising.**

Direct solicitation through **direct mail** is often a good way to elicit investor interest. Although direct mail generates low response rates (1-5 percent response rates are not uncommon), the low cost of the method keeps this cost-effective. The three key elements of any direct mail campaigns are a good mailing list, a well-written letter, and an effective response device. SRI's investment promotion experience has suggested that direct mail campaigns have been more effective when they are supported by follow-up **telemarketing calls** to the high priority potential investors.

Promotion of the SOE investment opportunity at **trade shows** is another strategy that has been used in privatization.[47] In Poland, the privatization of several glass sector companies was promoted at a national industrial trade fair. This was a good forum for the marketing of privatization offerings as many foreign investors were present. Marketing at trade shows can be effective because usually the companies attending trade shows are specifically looking for new trade and investment opportunities in their line of business. Trade show participation is more effective when follow-up contacts are made promptly to pursue the leads generated at trade shows.

Investment missions are often useful in generating investor interests by creating a strong on-site impression and promoting better understanding of the environment in which enterprises operate. Investment missions are often coordinated with and co-sponsored by chambers of commerce, multilateral organizations such as the International Finance Corporation (IFC) and United Nations Industrial Development Organization (UNIDO), or national organizations such as the U.S. Overseas Private Investment Corporation (OPIC).

Reverse investment missions have also been utilized. These are events which generally involve a group of government and/or company officials who promote sales offerings directly

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[47] See Technical Assistance to the Government of Poland in the Privatization of the Glass Sector, Price Waterhouse International Privatization Group, USAID Privatization and Development Project, 1991 to present.

to target investment groups overseas. This was the method by which the public share offering of a 39 percent stake in Grenada's National Commercial Bank was promoted to Grenadian expatriates and East Caribbean investors. In this particular case, reverse investment missions were conducted in order to maximize the participation of overseas Grenadian in the sale, and contributed to the full subscription of the offered shares.[48] The major disadvantage of this reverse investment mission was its time consuming and expensive nature.

Investment Conferences are another technique for attracting buyers. These conferences are held in the host country, or at an overseas site, often located closer to target buyers. Investment conferences usually last for one or two days. One or more projects for investment are presented to the target investors at the conference. One forum for investment conferences is a bidders' conference (see Box 11.1 below). Investment conferences are often organized around investment missions in host countries or at overseas locations.

Targeted advertising in specialized trade and industry journals and the international press is another effective channel for marketing SOEs. The principal advantage of advertising is its transparency and its ability to reach a wider audience beyond those targeted. In Nicaragua, investor interest in the sale of the Montelimar Beach Resort was solicited via an invitation to negotiate which appeared in the Economist and the Financial Times. During a period of one and a half months, over 50 responses to the advertisement were received.[49]

A combination of marketing mechanisms should be used to attract investors to privatization offerings. Promotion activities should be proactive and aggressive, allowing sufficient time for investors to assess the opportunity and indicate their interest. Although in some cases it may be possible to attract sufficient investor interest using an ad hoc sales strategy, an organized program is most likely to maximize participation in the sale and result in the realization of an optimal bid for the company. Box 11.1 below presents the marketing and promotion techniques employed in the privatization of the Philippine National Oil Company Dockyard and Engineering Corporation.

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[48] See Technical Assistance to the Government of Grenada, Price Waterhouse International Privatization Group, USAID Privatization and Development Project, 1993.

[49] See Technical Assistance to Government of Nicaragua, Price Waterhouse International Privatization Group, USAID Privatization and Development Project 1992 to present.

Box 11.1

The Sale of the Philippine National Oil Company Dockyard and Engineering Corporation

In order to concentrate on its core energy activities, the Philippine National Oil Company (PNOC) decided to sell its PNOC Dockyard and Engineering Corporation (PDEC) in 1992. A thorough privatization action plan was prepared and the marketing campaign was carefully orchestrated.

After the design of the sales strategy and the approval by the Philippines Government, PNOC embarked on a major marketing campaign to sell PDEC. An information memorandum as well as specific bidding guidelines outlining the terms of the sale were prepared for distribution to prospective investors. The information memorandum provided key information on PDEC for prospective buyers and intended to elicit their interest. It was directed to a specific group of target purchasers, presenting PDEC's strengths in a manner that can be easily related to the strategic needs of this target clientele. The information memorandum was brief and to the point, but well documented.

Following the preparation of the information memorandum, the next step was to advertise the sale of the company, the dates of the pre-bidding conference and the actual bidding in both the local and international press. The advertisements also included a short description of the company, merits of investments, and an invitation to request the information memorandum.

Locally, the ads were placed in the business section of the major Philippine newspapers and were printed in three consecutive weeks. Internationally, the ads were placed in trade journals and newspapers that had the highest visibility within the shipping industry. The ads were also placed in the Economist and the Wall Street Journal.

To complement the worldwide advertising efforts, a direct mail campaign was undertaken targeting specific investors that might have strong interests in PDEC. Specifically, PNOC and PW/IPG contacted the following potential investors:

- International shipping companies with considerable activities in Asia
- Major worldwide dockyard and engineering corporations
- Major Filipino investors/conglomerates
- Major foreign investors in the Philippines
- Major investment banks present in Philippines

Box 11.1
Continued...

While holders of Philippines debt would have been a good target, the Philippines Privatization Program strongly discourages debt/equity swaps and prefers cash sales for this transaction.

As a result of both the advertisement and the mailing campaign, respondents expressed their interest through letters of interest, which requested the information memorandum and bidding guidelines. The information memorandum was sold at a price which was high enough to discourage the not-so-serious respondents but low enough to avoid deterring potential investors.

The respondents who registered with PNOC by sending a letter of interest were invited to a pre-bidding conference. In this conference, PNOC management gave a thorough description of the company, key investment merits, objectives of the sale, and bidding rules and guidelines. Following the presentation, a video of the facilities was shown followed by a question and answer session. The next day, a tour of the facilities was arranged to familiarize the potential investors with PDEC's operation. The pre-bidding conference and the high number of participants were well publicized in the press to increase PDEC's visibility and investors' interest.

A bidding conference was held one month after the pre-bidding conference. Several bids were offered, and the highest one reached 64 percent above the minimum asking price. The bid was accepted and the privatization of PDEC was completed.

Source: The Sale of the Philippine National Oil Company Dockyard and Engineering Corporation, Technical Assistance to the Government of the Philippines, Price Waterhouse International Privatization Group, USAID Privatization and Development Project, 1991 to present.

C. Marketing Documents

The principal marketing document for companies undergoing privatization is a company prospectus. A prospectus is based upon the results of the company appraisal and valuation. (See Chapter III: Valuation and Guidelines for Asset Disposal). It should provide core information on the enterprise, including operational and financial highlights. As the key marketing document, the prospectus should be designed with the strategic interests of the target investor group(s) in mind, and should emphasize the strengths and key selling points of the firm, (see Box 11.2 below for the key selling points for SOEs).

The prospectus should be available to potential investors as steps in assisting their evaluation of the enterprise. In many countries, particularly where the enterprise is in a highly competitive industry, general enquiries in the sale are avoided by requiring a deposit or other form of security for the release of the prospectus document.

Distribution of the prospectus is often preceded by the advertisement of a company profile soliciting interest in the offering. The company profile provides a snapshot of the company's characteristics without delving into specifics at the level of the prospectus regarding financial or performance. A company profile is often included in an initial mailing to target investors.

Additional sales documents which may be required by investors include (i) asset inventories; (ii) legal audits; (iii) financial audits; and (iv) environmental audits. These documents are often reserved for investors that have shown a serious interest in the enterprise.

D. Creation of an Investor-Friendly Environment

The process of attracting investors to participate in privatization offerings is enhanced by a friendly investment climate. The legal and policy frameworks regulating pricing, trade, taxation, labor, foreign exchange convertibility, and repatriation, will all affect the value and marketability of state-owned enterprises to both foreign and domestic investors (see Chapter V: Policy and Regulatory Reforms; and Chapter X: Investment Regulations and Privatization). Thus, it is important that privatization and economic reforms are properly planned and sequenced to attain the overall economic objectives of the country.

A second issue regarding the creation of a supportive investor climate is transparency. The maintenance of a transparent marketing process is important both from the perspective of the potential investor and in terms of political considerations for the privatizing government. Thus all potential investors must have access to the same information, must have the same opportunities to perform due diligence, and the same period of time to prepare and offer. If investors sense an unlevel playing field, it will compromise the attractiveness of the sale, regardless of the attractiveness of the firm being privatized.

Box 11.2

Key Selling Points for SOEs

The development of promotional materials will depend in part upon the identification of the SOE's key selling points, or the unique characteristics of the company which are likely to generate investor interest. Several competitive advantages are possible for state-owned enterprises being privatized:

- *Cost Competitiveness* This factor is likely to be most attractive to foreign investors coming from countries where input costs are higher than in the host country. Frequently, the main cost advantage in developing countries is labor. Where the target investor group is an operator in the same or similar line of business, cost competitiveness can be highlighted as a major marketing point.

- *Access to Markets* For investors hoping to expand their operations, the prospects of acquiring a company with an established presence in a new market can be quite attractive. Thus, a state-owned enterprise may highlight its penetration of the local market as a key selling point to potential investors.

- *Potential to Enhance Performance* Under privatized management, the scope for improving performance and profitability can be very strong. Promotional materials should highlight areas for performance improvements, particularly when these may not be obvious to potential investors.

- *Financial Returns* For profitable state enterprises or those with high performance enhancement prospects, a key selling point to investors can be high financial returns. This is particularly important where investor participation is solicited in a public offering.

Source: Key Selling Points for SOES. Privatization Marketing Handbook, Arthur Young, prepared for USAID Center for Privatization, 1990.

E. Lessons Learned on Investment Searches

1. The definition of a target investor profile will depend upon the sale objectives and method of privatization. Targeting specific investors helps to rationalize the search process and will contribute to the quality of the transaction.

2. The key selling points of the enterprise should be identified and considered in the development of promotional materials to market the offering.

3. The most common marketing mechanisms include: direct mail and telemarketing, trade show participation, investment missions, targeted advertising, and investment conferences. A combination of methods should be used to maximize investor response to the offering.

4. The key marketing document is the company prospectus which includes operational and financial highlights of the company. As the primary marketing document, the prospectus should be carefully designed to appeal to the interests of the target investment group(s).

5. Privatization marketing efforts must be reinforced by an investor-friendly environment. In addition to appropriate policy, regulatory, and investment reform, governments should also ensure the transparency of the investor search process.

XII. CONCLUSIONS AND IMPLICATIONS FOR THE ZAMBIAN PRIVATIZATION PROGRAM

A. Introduction

This chapter synthesizes the main lessons learned from Chapters I-XI of this report, and draws some initial conclusions about how they might apply to the Zambian privatization program. The information presented in this chapter about Zambia's privatization program and prospects is based largely on recent data gathered by SRI International in Zambia.

B. Zambian Privatization Program Background

In 1991, the people of Zambia inaugurated a new economic and political era when they voted into power the Movement for Multiparty Democracy (MMD) Party. President Chiluba and the MMD were elected to power on a platform that clearly stated the intention "to promote privatization in order to optimize resource allocation, enhance the productivity of the private sector, and help reduce the Government deficit."

Realizing that parastatals are primary obstacles to economic growth and private sector development, the Zambian government has approved a privatization plan to divest the government of all its holdings except a few public utilities which are natural monopolies. Over a five-year period, some 150 parastatals are scheduled to be privatized through sales, liquidations or contracting out to private management. In so doing, the state's interest in the economy would be reduced from 80 percent to 20 percent.

The Zambian Cabinet approved the privatization plan in March of 1992, and a Privatization Act was passed by Parliament in July of the same year. The Act established the Zambia Privatisation Agency (ZPA) with a Board of Directors consisting of 3 government members and 8 private sector representatives.

The three main methods of SOE divestiture proposed by the ZPA include: (i) private sale through tender, including management buy-outs (MBOs); (ii) direct negotiations (particularly with minority share holders holding preemptive rights); and (iii) public offerings.

The Zambian privatization program is receiving substantial support from several donor sources including USAID, ODA (British Overseas Development Agency), GTZ (German Technical Assistance Agency), NORAD (Norwegian Agency for Development), UNDP (United Nations Development Agency), and the World Bank.

C. Guidelines for Policy and Program Measures for the Zambian Privatization Program

In this section, guidelines for Zambia privatization program are presented by the consultant team. These measures are based upon the lessons learned from other countries' privatization experiences, which have been profiled in Chapters I to XI of this report.

1. Establishing and Maintaining Clear and Transparent Guidelines and Procedures for the Disposal of Assets.

Through its Privatisation Law and implementing procedures, Zambia has already begun to establish clear guidelines on the methods of privatization and how it will treat issues such as existing debts of parastatals, tendering processes, target buyers, existing shareholders and employees rights, etc. Experience from other countries suggests that all successful programs have provided clear and transparent guidelines.

Countries such as Malaysia have established privatization guidelines laying down clearly how assets are to be valued and transacted. These guidelines ensured that competition was used to so that the state received fair market value for the assets, and that valuation and negotiations followed strict technical criteria. Other countries such as Argentina, Bangladesh, Brazil, Chile, France, Philippines and Tunisia enacted mandatory guidelines to establish clear minimum standards to ensure orderly disposition, maximize returns to the state, and preserve a fair process to the general public. Senegal established a privatization law in 1987 that, among other things, specified that shares of an SOE be sold by competitive bidding unless justified by exceptional circumstances.

The successful experiences of other countries would indicate that establishment and wide publication of Zambia's procedures and policies on valuation, pre-qualification of bidders and disposal of assets could have a major influence on the credibility of the program and its acceptance by the public at large. The articulation of this policy could be followed up by frequent updates and progress reports presented to the public stating inter alia how each company is sold, the names of the buyers, and the agreed selling price and terms, as specified in Zambia's Privatisation Law.

2. Overcoming Major Obstacles to Privatization

A crucial early step in Zambia's privatization program should be to identify many of the potential major obstacles and constraints to implementing the program. Once these obstacles and risks have been properly identified, the design of the program can be tailored to overcome or sidestep these hurdles.

Based on the experience of many other countries undergoing similar reform programs throughout the world, some of the constraints Zambia is likely to encounter include:

a. government's reluctance to sell

b. political and social resistance to privatize

c. financial market constraints

d. legal barriers and issues

e. limited administrative capacity

One of the first obstacles to overcome is often the **government's reluctance to sell**, even in cases where policy decision to divest all non-strategic parastatals has already occurred. Based on the experiences of other countries, two of the reasons for this reluctance are:

- unwillingness to give up profitable enterprises; and

- some governments draw back when it is discovered that enterprises are not sellable at the asking prices needed to recover investment costs.

Other important obstacles in any country are the **political and social obstacles** associated with:

- the employed labor force which fears being retrenched;

- parastatal executives and board members, who in many cases have been appointed based on criteria other than managerial skills, have concerns about being dismissed;

- government officials overseeing parastatals who feel their authority is being eroded;

- government officials may be hesitant about accepting low asking prices for parastatals out of fear of corruption accusations; and

- the intellectual community may be against privatization on ideological grounds if the beneficiaries of it are perceived to be the affluent class.

Legal restrictions can also be an impediment to privatization. The Articles of Incorporation of many parastatals set up as mixed joint stock companies in Zambia contain certain restrictions about the transferability of all or certain classes of shares and provide preemptive rights to existing shareholders. These provisions will have to be taken into account when transferring shares.

Finally, the implementation capacity of government decision makers and technical staff, already saddled with numerous economic reform issues, must be considered when setting up the timetable for the implementation of the divestiture and parastatal reform programs. The development of technical skills in the areas of valuation, investment finance, negotiation, and legal reform is vital to countries wishing to achieve sustainable privatization programs.

These factors and other constraints will need to be carefully considered by privatization policymakers in Zambia in their design and implementation of the program. Some of the strategies utilized elsewhere which Zambia might consider applying to overcome social and political constraints include: (i) ensuring that the process remains open and transparent; (ii) encouraging widespread share ownership to broaden political support; and (iii) providing compensation to labor through shares, severance pay, and job search assistance.

3. Setting Targets

The most effective implementation strategies are often the simplest. First, an honest appraisal of the current status should be undertaken. Second, ambitious but realistic goals should be set. Planners should then work backwards to determine how the goals can best be achieved.

Objectives and targets, both quantitative and qualitative, act as driving forces for tactics and actions. These might include numbers of privatizations, shares of production to be shifted to private hands, policy reforms in given functional areas, and other benchmarks. These targets will serve as the basis for the privatization implementation program.

The GRZ has recently set some ambitious targets for its privatization program, setting the objectives of some 30 privatizations by year-end 1993, and some 150 parastatals to be sold, liquidated, or contracted out to private management over the next five years. While successfully meeting these objectives would be desirable and is technically feasible, experience from other countries suggests the targets may still be somewhat optimistic in light of the results of privatization programs elsewhere, particularly in other African countries.

Based on the lessons learned from elsewhere, the GRZ may want to consider setting and adhering to an ambitious set of performance targets. However, in the first year of a country's privatization program, adjustments should be made to fit the circumstances. It should be emphasized that there is a clear trade-off between transparency and speed. Especially in the first year of the program when establishing credibility is most critical, lessons learned from other countries suggest that higher priority should be given to transparency than to speed.

4. Widespread Ownership

An effective spread of ownership among large numbers of small shareholders has been successfully achieved in privatizations in countries such as the United Kingdom and Jamaica. The strategy of those countries was that popular ownership would: (i) help mobilize capital from a new class of investors; (ii) diffuse potential criticisms about privatization leading to concentrations of wealth among economic elites; and (iii) help ensure that the privatized companies would not be subsequently re-nationalized.

The main techniques used in these and other countries to promote popular ownership have been: (i) providing special incentives, loans or discounts to the employees in particular or small investors in general; (ii) intentionally setting the offering price low enough to ensure a strong response on the first major public offering; (iii) extensive publicity and promotion before the flotations; and (iv) placing limits on the amounts of shares to be allocated to any one individual or group.

While widespread ownership is desirable, some of the above methods need to be balanced carefully against the economic costs of "giving away" stocks too cheaply or diluting ownership concentration so thinly that no one group has a strong enough financial stake in a company to exert pressure on management for good performance.

The concept of encouraging an effective spread of ownership among a large number of small shareholders has a great deal of merit. Given the GRZ's interest in this issue, some of the techniques which could be employed include offering special incentives or discounts to employees and small shareholders. Targeting small investors through public offering could be appropriate, once the securities market is established. This could be done through 100 percent public offerings, or a mix of private sales and public offerings.

5. <u>Safety nets</u>

In the short run, privatization tends to be associated with worker retrenchments. In the longer term, the objective is that privatization leads to increased employment through a more dynamic and expanding private sector. However, most often the longer-term employment benefits from privatization tend to be less visible than the short term retrenchments.

In Zambia's case, many of the firms targeted for privatization in 1993 are relatively profitable operations. Since many of these companies have commercial management and relatively efficient work forces, the changes brought about by the government selling its shares in these companies are likely to have a small impact on the structure of the existing work force. Retrenchments in those cases are not likely to be significant.

However, in the case of the companies to be liquidated, there will be cases where existing employees are retrenched, potentially creating social disruptions. In addition, if the pace of privatization picks up, there will clearly be many privatizations which will lead to restructured work forces.

Safety nets in countries pursuing parastatal reform have included a number of approaches ranging from lump sum severance payments to special credit, training, employment or redeployment schemes. Experience in other countries with credit, training, and employment (public works) schemes has generally been much less successful than severance payments.

It would be advisable and prudent for Zambia to design a safety net system to mitigate the social costs associated with the parastatal reform program. Of all the schemes tried, lump sum payments appear to be the easiest to administer, are most cost effective, and are most likely to have a direct impact. Severance payments could be financed from divestiture proceeds or possibly in part through foreign aid assistance, particularly through structural adjustment or social dimensions of adjustment assistance. Job search assistance is also very helpful and not very costly.

6. Using Privatization as Catalyst for Policy Reform

Privatization is not an end in itself. It would be a mistake to focus only on privatization -- rather than economic efficiency -- as the ultimate goal. Policy reforms to ensure competitive markets in the areas of pricing, trade policy reform, flexible labor policies, and eliminations of legal monopolies are all needed in order to maximize the efficiency gains from privatization. Not all of these policies can be adjusted at once, nor should privatization be delayed until all these problems are solved. Private enterprise development and policy reform should be built into the privatization process in an iterative way. Privatization should be used as a catalyst for further reform in these areas.

7. Privatization Methods

There is no single best method for privatizing companies. Different forms of privatization are available depending on the type of enterprise to be divested and the objectives of the government. Two common methods of privatization involve **public offerings of shares or private sale** (through tendering or direct negotiation). Other methods for Zambia to consider include: **employee or management buy-outs, transferring small businesses to operators, and management or leasing contracts, and deregulation.** Many parastatals offered for sale in developing countries end up being sold through **asset sales or liquidations** because of their poor financial positions. Most successful privatization programs have pursued a variety of these methods concurrently, maintaining a "diversified privatization portfolio".

Public share sales are appropriate for larger, usually profitable and well managed companies that can attract large numbers of investors through a flotation in cases where the stock market is active. When specific management or technical expertise is sought for the company, **public tendering or private sales** are appropriate. **Deregulation** is an appropriate way to encourage private participation in economic activities which formerly excluded private companies because of monopolies granted to parastatals.

In situation where the net worth or a small SOE does not justify the costs of detailed valuation and negotiation, privatizing countries have used the **transfer of ownership or management/labor buy-out option.** Companies which are not viable and have negative net worth generally should be closed down in **liquidation sales,** following receivership or bankruptcy procedures. **Leasing and management contract options** are often utilized when the sale of assets cannot be achieved in the first stage, but it is felt that private management will help to improve profitability and will eventually lead to full privatization.

Zambia will probably wish to pursue a variety of privatization methods simultaneously, adjusting emphasis over time on the basis of results achieved.

8. Issues Related to Specific Privatization Methods

The selection of a particular option leads to a series of tasks that must be completed. In the beginning of the program, the privatizing country governments generally employ those options which require the fewest number of steps.

For example, a highly profitable company might not require an assessment of its commercial prospects and may not require a restructuring of its balance sheet. In most cases an assessment of existing shareholders rights is likely to be important in Zambia. The charters of mixed joint stock companies provide the rights of "first refusal" to existing shareholders in the case of a sale of ownership shares. These rights will have to be taken into account while ensuring that some competition for shares takes place to maximize the price the state receives.

There is a fairly significant number of parastatals in Zambia targeted for privatization which are profitable or at least breaking even. These SOEs could easily interest private buyers. These companies could either be sold at an early stage of privatization through competitive tendering, or in the cases of the larger and more profitable ones, through public flotation, when the stock market is established.

These more profitable companies are likely to lessen needs for financial, operational, or legal restructuring. Consequently, they are likely to have fewer impacts on redundancies and social disruptions. Sales of shares through the stock exchange would also ensure both transparency and widespread distribution of benefits and support for the program.

Regarding liquidation, the Zambian laws on bankruptcy define methods for winding up of companies with provisions for the rights of creditors and shareholders. Relatively quick and straightforward action can be taken to liquidate nonviable parastatals, and asset sales would follow.

Other countries with large numbers of enterprises to be privatized have pursued a strategy whereby the profitable companies for which shares can be offered on the stock exchange or through competitive tendering were divested first. This provides a positive demonstration effect and general support for privatization. Based on the successful experience of other countries embarking on major privatization efforts, the GRZ might consider beginning privatization with a select number of profitable companies for which shares can be offered on the stock exchange or through competitive tender. Quick action can also be taken on liquidation following existing laws and procedures. This strategy may also be appropriate for Zambia.

9. Mechanisms for Privatization in Constrained Financial Markets

Privatization in Zambia could be constrained by the weak conditions of the domestic financial markets. The Zambian financial market is not very active to begin with, but is also showing signs of structural stress. The financial markets in Zambia are characterized by:

- an absence of financial market depth, including sources of medium and long-term credit for investment purposes;
- a lack of non-bank financing mechanisms such as equity markets, venture capital funds, and mutual funds;
- a scarcity of liquidity in the banking system for working capital purposes;
- a shortage of available cash flow surpluses from existing businesses; and
- an inflationary environment which dampens investor interest.

In order to overcome these constraints, Zambia will eventually need to finalize the changes at the macro level needed to encourage innovation and creativity at the transaction level. The New Banking Act in Zambia provides the initial regulatory modifications necessary to establish venture capital funds, mutual funds, merchant banking and other instruments to make additional equity and risk capital accessible for privatization.

Privatization trust funds, venture capital funds and mutual funds are some of the new instruments utilized in other countries which Zambia could introduce to provide capital for the privatization program. Until the stock market is established banks could trade in over-the-counter share sales. Medium-term debt issues and debt-equity swaps can also be utilized to raise capital for privatization. Management/employee buy-outs using pension funds and retained earnings represent another innovative financing mechanism which help overcome the scarcity of capital for privatization investment, and could be considered for Zambia.

10. Open Environment for Investors

Privatization in Zambia, as well as other countries, faces the potentially limiting constraint that there may be a narrow field of qualified buyers. As mentioned above, the field is constrained to begin with by: (i) thin capital markets in Zambia; (ii) a constrained banking system; (iii) a lack of surplus cash flow in existing businesses; and (iv) a high-inflation environment.

The field of buyers will be further narrowed if foreign buyers or certain ethnic groups or classes are excluded by law or by practice. This question becomes especially important as the volume of privatization increases, and the demands on local financial markets intensify. The utilization of foreign capital can be particularly helpful in minimizing excess demands on domestic credit.

Recognizing that the existing pool of private capital and managerial skills is limited Zambia may wish to follow the example of other successful privatization programs such as Jamaica and Togo and include all classes of potential investors, foreign and local in the privatization process. In particular, foreign investors should be welcome in line with the Zambia's Investment Code. Foreign investors could be targeted through investor searches and other marketing techniques.

11. Environmental Issues Affecting Privatization in Zambia

Potential liability for environmental damage caused by former SOEs was initially a major stumbling block to the privatization program in several Eastern European countries. In all countries, investors want to know the extent of their liability for environmental damage or violation due to the former SOE before investing.

Zambia is not currently a very litigious society compared with the United States or many European countries. In addition, the extent of environmental degradation caused by SOEs in Zambia is not of the same magnitude as that of many Eastern European countries. Nonetheless, with new emphasis on stronger environmental protection in Zambia and throughout the world, it will be important for Zambia to eventually have in place an environmental policy which will set new standards for the companies being privatized.

Currently there is an Environmental Act in Zambia, but no implementing regulations have yet been enacted. USAID is planning on financing environmental liability estimations for a number of the SOEs up for sale. Zambia will need to establish a clear set of policies and regulations regarding environmental liabilities.

Establishment of standards for clean air, clean water, and solid waste emissions through Zambia's Environmental Act and implementing regulations will make it possible to establish yardsticks for current discharges and site clean-up costs. Following the strategies of Poland and Germany, it may be desirable for Zambia to conduct environmental site audits prior to privatization. Responsibility for current discharges should be given to buyer. The cost of site clean up should be borne by the government through escrow accounts. Other countries' experience suggests government liability for past environmental damage should be bound as much as possible by the use of escrow accounts, restricted indemnities, and specified time frames.

12. Establishing a Strategy to Deal with Large Numbers

The government has already decided that at least 150 non-strategic enterprises will be privatized. Eventually the GRZ will need to develop an approach for dealing with the large number of privatizations and for disposing of them relatively rapidly following predetermined criteria and guidelines.

One approach taken by many Latin American countries and now being started in Eastern Europe is to establish holding companies to carry out privatization, sometimes as a routine part of their corporate operations. These holding companies are given equity positions in subsidiary parastatal companies and are asked to divest all or most subsidiaries. This basically amounts to "privatizing" the privatization process. Obviously the level of commitment of the professional management of the holding company to the overall goals of the privatization program is of paramount importance.

Eventually the GRZ will need to develop an approach to deal with the large numbers of firms to be privatized. The holding company approach is one that many countries are using to deal with the large volume of privatization transactions. This is one approach the GRZ might consider for some time in the future.

13. A Checklist for Privatization

The checklist in Chart 12.1 below illustrates the lessons learned from worldwide privatization experience. It is hoped that the knowledge gained about successes and failures of other countries' programs will assist Zambian policymakers in the successful design and implementation of their own privatization program.

Chart 12.1

A CHECKLIST FOR PRIVATIZATION

- ✔ Establish and maintain guidelines for the disposal of assets. The articulation of privatization policies should be followed up by frequent updates and progress reports to the public.
- ✔ Develop a proactive strategy to overcome political and social opposition to privatization.
- ✔ Experience shows that labor does not need to lose in privatization if governments pay attention to easing the social costs of privatization through severance pay, retraining, and job search assistance.
- ✔ Set ambitious, but realistic, targets. Particularly in the first year of the program, when credibility is critical, higher priority should be given to transparency than to speed.
- ✔ Widespread local ownership should be promoted through such techniques as setting aside shares in offerings, extensive publicity and the encouragement of management/labor buy-outs.
- ✔ SOEs functioning in competitive markets are prime candidates for privatization. Their sale is simple compared with public monopolies, and they require little or no regulation.
- ✔ Rather than restricting the market by excluding foreign investors or favoring certain ethnic groups, it is better to keep the market open to all classes of investors, consistent with the Investment Code.
- ✔ Avoid significant new capital investments in privatization candidates. Rather, prepare for sale by carrying out legal and organizational changes, and labor adjustments.
- ✔ Policy reforms to ensure competitive markets are needed in order to maximize efficiency gains from privatization. Policy reforms should be built into the privatization process in an iteractive way.

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